Office-Supreme Court, U.S.
FILED
MAY 26 1961
JAMES R. BROWNING, Clerk

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1960

No. [redacted] 118

FOOD MACHINERY AND CHEMICAL CORPORATION, a corporation, *Petitioner,*

vs.

THE UNITED STATES, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

HARRY R. HORROW,
225 Bush Street,
San Francisco 4, California,
Attorney for Plaintiff.

ROBERT W. MORRISON,
PILLSBURY, MADISON & SUTRO,
225 Bush Street,
San Francisco 4, California,
Of Counsel.

PERNAU WALSH PRINTING CO., SAN FRANCISCO

Table of Contents

	Page
Opinion below	1
Jurisdiction	2
Question presented	2
Statutes and regulations involved	3
Statement	3
Analysis of opinion below	9
Reasons for granting the writ	12
Conclusion	21
Appendix A	23
Appendix B	73
Appendix C	Pocket

Table of Authorities Cited

Cases	Pages
American Automobile Association v. United States, 181 F. Supp. 255, certiorari granted, 364 U.S. 813	20
Apex Electrical Manufacturing Co., 16 T.C. 1171, affirmed, 202 F.2d 151	14
Breeze Corporations v. United States, 127 Ct.Cl. 261, 117 F.Supp. 404	13
Brown v. Helvering, 291 U.S. 193	16
Commissioner v. Fifth Avenue Coach Lines, Inc., 281 F.2d 556, certiorari applied for, January 7, 1961	14, 17
Consolidated Edison Co. of New York v. United States, 279 F.2d 152, certiorari granted, 364 U.S. 890	20
Continental Tie & L. Co. v. U.S., 286 U.S. 290	9, 10, 11, 15
Fifth Avenue Coach Lines, Inc., Commissioner v., 281 F.2d 556, certiorari applied for, January 7, 1961	14, 17
Globe Corporation, 20 T.C. 299, acq.	14
H. Liebes & Co. v. Commissioner of Internal Revenue, 90 F.2d 932	14
Henry Hess Co., 16 T.C. 1363, affirmed, 210 F.2d 553	14
Jamaica Water Supply, 42 B.T.A. 359, affirmed, 125 F.2d 512, certiorari denied, 316 U.S. 698	14
Lichtenberger-Ferguson Co. v. Welch, 54 F.2d 570, on remand, 14 F.Supp. 396	14
Liebes, H. & Co., v. Commissioner of Internal Revenue, 90 F.2d 932	14
Lucas v. American Code Co., 280 U.S. 445	16
Luckenbach Steamship Co., 9 T.C. 662, acq.	14
Mira Loma Flight Academy v. U.S., 55-2 USTC, par. 9612	14
North American Oil v. Burnet, 286 U.S. 417	16
Safety Car Heating Co., U.S. v., 297 U.S. 88	14, 18
Security Mills Co. v. Comm'r., 321 U.S. 281	10, 16
Spring City Co. v. Commissioner, 292 U.S. 182	9, 16
U.S. Cartridge Co. v. U.S., 284 U.S. 511	14
U.S. v. Safety Car Heating Co., 297 U.S. 88	14, 18

Statutes and Regulations

Internal Revenue Code of 1939: Pages
Sec. 41 (26 U.S.C., 1946 Ed., sec. 41) 3, 73
Sec. 42(a) (26 U.S.C., 1946 Ed., sec. 42(a)) 3

Contract Settlement Act of 1944, c. 358, 58 Stat. 649:
Sec. 6 (41 U.S.C., sec. 106) 2, 3, 4, 8, 18, 19, 73

5 U.S.C. sec. 22 18

10 U.S.C. sec. 2202 18-19

28 U.S.C. sec. 1255(1) 2

Treasury Regulations 111, sec. 29.42-1 .....3, 9, 10, 78

Procurement Regulations and Joint Termination Regulations, 10 Fed. Register 10449:
Sec. 845.513 (JTR 513) 3, 18, 81
Sec. 845.531 (JTR 531) 3, 19, 81, 82
Sec. 845-532 (JTR 532) 3, 19, 82, 83
Sec. 845.533 (JTR 533) 3, 19, 83, 84
Sec. 845.582 (JTR 582) 3, 19, 84
Sec. 845.583 (JTR 583) 3, 19, 85
Sec. 845.584 (JTR 584) 3, 19, 86

Armed Services Procurement Regulations, 23 Fed. Register 9221:
Sec. 8.203 (32 CFR sec. 8.203) 3, 18, 87
Sec. 8.211-2 (32 CFR sec. 8.211-2) 3, 19, 87
Sec. 8.211-3 (32 CFR sec. 8.211-3) 3, 19, 88
Sec. 8.211-4 (32 CFR sec. 8.211-4) 3, 19, 89
Sec. 8.300 (32 CFR sec. 8.300) 3, 18, 89
Sec. 8.301 (32 CFR sec. 8.301) 3, 19, 89
Sec. 8.303 (32 CFR sec. 8.303) 3, 19, 90
Sec. 8.701 (32 CFR sec. 8.701) 3, 18, 91

Miscellaneous

Mimeograph 5897, C.B. 1945, 131 .....8, 9, 10, 14, 15, 79

17th New York Institute on Federal Taxation, p. 191 15

"Terminations of Military Prime Contracts July 1959—June 1960" (Office of the Secretary of Defense) 19

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1960

No. ____

FOOD MACHINERY AND CHEMICAL CORPORATION, a corporation,	*Petitioner,*
vs.	
THE UNITED STATES,	*Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

Food Machinery and Chemical Corporation, a corporation, by its attorney, Harry R. Horrow, petitions for a writ of certiorari to review the judgment of the United States Court of Claims entered in this case.

OPINION BELOW

The findings of fact, conclusion of law and opinion of the Court of Claims and the dissenting opinion of Judge Whitaker (Appendix A, infra, pp. 23-72) are reported at 286 F.2d 177.

JURISDICTION

The judgment of the Court of Claims (Appx. A, infra, p. 72) was entered on December 1, 1960. A motion for rehearing was filed on December 27, 1960, and was overruled on March 1, 1961. The jurisdiction of this Court is invoked under 28 U.S.C., section 1255(1).

QUESTION PRESENTED

During World War II taxpayer was engaged in the manufacture of amphibian tanks and spare parts under prime fixed-price contracts with the Navy Department. Before taxpayer had completed performance, eleven of its contracts were terminated for convenience of the Government on various dates in July and August, 1945. Pursuant to the Contract Settlement Act of 1944, taxpayer and the Navy Department negotiated a settlement by agreement in the year 1946 of the fair compensation to be paid taxpayer for the termination of its contracts, which settlement provided for the allowance to taxpayer of a profit in the amount of $906,621.81.

The question is whether taxpayer's profit allowance on its terminated contracts accrued as income in the taxable year ended September 30, 1945, at which time the court below held that the parties had reached a stage of sufficient agreement for the ascertainment of taxpayer's profit allowance, or whether said profit allowance did not accrue as income until the calendar year 1946, taxpayer's taxable year in which negotiations were completed and the settlement of taxpayer's claims occurred.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved (sections 41 and 42(a) of the Internal Revenue Code of 1939; section 29.42-1 of Treasury Regulations 111; section 6 of the Contract Settlement Act of 1944; sections 513, 531, 532, 533, 582, 583 and 584 of the Joint Termination Regulation; and sections 8.203, 8.211-2, 8.211-3, 8.211-4, 8.300, 8.301, 8.303 and 8.701 of the Armed Services Procurement Regulations) are set forth in Appendix B, infra, pp. 73-100.

STATEMENT

The material facts, as set forth in the findings of fact and opinion of the Court of Claims (Appx. A, infra, pp. 45-72), may be summarized as follows:

Taxpayer, a Delaware corporation with its principal office at San Jose, California, was engaged in the manufacture of amphibian tanks and spare parts under fixed-price prime contracts with the Navy Department during World War II. Taxpayer kept its books and filed its returns on the accrual basis.

Before taxpayer had completed performance, eleven of its contracts were terminated for convenience of the Government under the provisions of the Contract Settlement Act of 1944 and the Joint Termination Regulation by termination notices issued on various dates in July and August of 1945.

Taxpayer had become aware early in 1945 that its contracts might be terminated. On June 20 and 21 and during the week of July 2, taxpayer held pretermination con-

ferences with the Navy Contracting Officer in charge of taxpayer's contracts and other Navy representatives. At these conferences they discussed means of calculating costs due to cancellation, the manner of counting and classification, preservation and disposal of inventories, the rate of profit taxpayer was to receive, and the approximate amounts involved. Taxpayer proposed a 6.4 per cent rate of profit; the Navy offered the terms generally used by it of 3 per cent on materials and purchased parts and 10 per cent on work in process. Taxpayer's estimate of work in process as at least 25 per cent of its inventories would have allowed an over-all rate of 4.75 per cent at the Navy's terms. Discussion led to an oral agreement on a profit rate of 4.875 per cent.

On July 19, 1945, the Navy submitted to taxpayer a draft of a proposed pretermination agreement referring to five of taxpayer's contracts, which draft was noted as not in final form and not binding on the Government. The draft provided a 4.875 per cent rate of profit. Before the draft was put in final form for execution, the war ended and taxpayer's contracts were terminated. Post-termination activities proceeded under the Contract Settlement Act and the Joint Termination Regulation and not under the proposed pretermination agreement.

Under section 6 of the Contract Settlement Act (41 U.S.C. 106), contracting agencies were required to provide speedy and fair compensation for the termination of war contracts and to establish methods and standards for determining said fair compensation, which methods and standards were to take into account certain specified items of costs, including a reasonable profit allow-

ance, and to exclude other items of costs. The agency could settle a termination claim by negotiated agreement with the contractor or by unilateral determination of the amount due on the claim or by a combination of both methods. No settlement providing payment of more than $50,000 was binding on the Government until reviewed and approved by a Settlement Review Board. Claims were to be settled by negotiated agreement to the maximum extent feasible.

Negotiated agreement was the only method of settlement used in settling taxpayer's termination claims.

At a meeting on September 18, 1945, taxpayer's president and the Navy Contracting Officer reached an oral understanding that the 4.875 per cent profit rate remained mutually agreeable and would be claimed by taxpayer when it submitted its claims. By letter dated September 21, 1945, the Navy Contracting Officer confirmed this understanding. It was also understood that the rate of profit was subject to review by the Government's Settlement Review Board in Washington, D. C., and that written agreements would have to be reached when the negotiations were completed and the Settlement Review Board had approved taxpayer's claims (Finding 23).

This is the stage to which matters had progressed when taxpayer's fiscal year came to an end on September 30, 1945.

On November 12, 1945, taxpayer requested permission to consolidate some of its termination claims and set August 17, 1945, as the consolidated termination date. On November 15 taxpayer asked to be permitted to submit one settlement proposal covering all its terminated con-

tracts and to apportion charges pro rata. This requested procedure was authorized verbally by the Navy Contracting Officer on or about November 26 and was confirmed by the Supervisor of Shipbuilding by letter dated December 7.

Taxpayer did not submit its first settlement proposal until November 27, 1945. In this proposal taxpayer disclosed a total inventory of metals, purchased parts, finished components and work in process of $18,618,592.43, and claimed a profit of $907,656.38, by applying the 4.875 per cent rate of profit to the total inventories.

The claim was received by the Bureau of Ships' Contract Termination Section in Washington on or about January 3, 1946. With the claim was a report dated December 14, 1945, by the Navy's Supervisor of Shipbuilding responsible for taxpayer's contracts. The report stated that Navy personnel had examined the inventories, checked prices, and found materials in good condition and properly allocable to the terminated contracts. The report referred to questionable items in the claim such as taxpayer's failure to deduct cash discounts from costs. Since taxpayer waived other items of cost which it might have claimed, no adjustment was required. The report also called attention to the fact that the requested profit was based on the rate tentatively agreed upon at the meeting of September 18, 1945, but that purchased parts constituted a larger percentage of the total inventories than was anticipated during the negotiations on the profit rate.

At a meeting on January 8, 1946, between taxpayer and representatives of the Navy, the reasonableness of the 4.875 per cent rate of profit was questioned by the Navy

Contracting Officer because it had been predicated on an estimate that at least 25 per cent of taxpayer's inventories consisted of work in process, whereas taxpayer's settlement proposal showed work in process of only approximately 7 per cent. The Navy Contracting Officer requested taxpayer to supply him information to justify the reasonableness of an allowance of profit at the 4.875 per cent rate. Taxpayer complied by letter dated February 13, 1946.

In that letter taxpayer pointed out that it had included as work in process only such items as were unquestionably that, while much work which could properly have been included was omitted due to the impossibility of segregating and identifying it. Taxpayer noted additional items which could have been properly classified as work in process, but which had not been so classified, and also agreed to waive certain substantial items of cost.

On March 26, 1946, the Navy Contracting Officer submitted his written proposals for settlement of taxpayer's claims to the Settlement Review Board. With one exception, he recommended approval of taxpayer's claim as it was submitted on November 27, 1945, including the allowance of profit at the rate of 4.875 per cent. The exception concerned freight charges in the sum of $21,222. A dispute had arisen on certain freight charges claimed by taxpayer as a part of its inventory costs, and taxpayer, after negotiation, agreed to decrease its claim for metals inventory by the amount of $21,222, and the Settlement Review Board was so advised.

On March 27, 1946, after considering the evidence before it and discussion of the various items of the claim, the

Settlement Review Board certified its approval of the proposed settlement agreement as it was contained in taxpayer's claim and the report and recommendation of the Contracting Officer. This constituted a partial settlement of the matters involved in the termination of the contracts and was recognized by the Settlement Review Board as such (Finding 42). The action of the Board was approved by the Chief of the Bureau of Ships. By letter dated April 11, 1946, the Navy submitted to taxpayer for execution two supplemental agreements covering taxpayer's termination claim as approved by the Settlement Review Board and the Chief of the Bureau of Ships, which provided for the allowance to taxpayer of a profit on all of its claims in the amount of $906,621.81, the amount in dispute in this proceeding. Taxpayer did not receive payment of any part of said profit allowance until after these agreements were executed.

On December 29, 1945, the Commissioner of Internal Revenue granted taxpayer permission to change its accounting year for tax purposes from a tax year ending September 30 to a calendar year ending December 31. Taxpayer filed income and excess profits tax returns for the short taxable period October 1, 1945, to December 31, 1945, and has subsequently prepared and filed its returns on the calendar year basis.

Shortly after the enactment of the Contract Settlement Act of 1944, the Commissioner of Internal Revenue promulgated Mimeograph 5897 (C.B. 1945, 131) which provided that compensation for termination of Government contracts pursuant to the Contract Settlement Act is accruable in the year of termination for the reason that the

Act by its terms definitely fixed the right to and measure of such compensation. *Continental Tie & L. Co. v. U. S.*, 286 U.S. 290, was cited as authority for this position. This ruling was incorporated in Treasury Regulations 111, section 29.42-1.

Although during settlement negotiations an attorney for the Navy suggested that the profit allowance was accruable as income in the calendar year 1946, taxpayer included in its income and excess profits tax returns for its taxable year ended September 30, 1945, an estimated profit allowance of $907,656.38 on its terminated contracts, because of the aforesaid position taken by the Commissioner of Internal Revenue in Mimeograph 5897.

Taxpayer filed a timely claim for refund based on the ground that said profit allowance was erroneously included in income in its taxable year ended September 30, 1945.

On the basis of his position taken in Mimeograph 5897 that a fixed and determined right to a reasonably ascertainable amount of profit allowance existed solely by reason of termination and at the time termination occurred, the Commissioner of Internal Revenue disallowed taxpayer's claim for refund, resulting in taxpayer's timely petition to the Court of Claims.

ANALYSIS OF OPINION BELOW

The Court of Claims stated that the time when a right to receive or liability to pay an ascertainable amount becomes fixed is decisive of the proper time for accrual, citing *Spring City Co. v. Commissioner*, 292 U.S. 182, and

Security Mills Co. v. Comm'r., 321 U.S. 281. The Court of Claims then held that the Contract Settlement Act of 1944 did not establish all of the factors necessary to fix the amount of taxpayer's compensation for its terminated contract, but left the rate of profit to be resolved by a negotiated settlement between taxpayer and the Government. The Court of Claims thus rejected the position taken by the Government, as set forth in Mimeograph 5897 and incorporated in section 29.42-1 of Treasury Regulations 111, that taxpayer's profit allowance on termination of its contracts accrued as income at the time of termination. A claim for compensation for terminated Government contracts was distinguished from an award for compensation to the railroads under the Transportation Act of 1920, considered by this Court in the *Continental Tie & Lumber* case, supra. The majority of the Court of Claims also rejected taxpayer's position that its compensation was not accruable as income until its claim was allowed and a final settlement was reached which was binding on both taxpayer and the Government. Admittedly this did not take place until 1946, when the negotiated settlement was approved by the Settlement Review Board of the Navy Department. Instead, the majority of the Court of Claims, adopting a novel, subjective test for accrual, appraised the state of negotiations in the settlement of taxpayer's claim for compensation, and considering that the "negotiations between the parties had reached a stage of sufficient agreement by the end of fiscal [year] 1945" (Appx. A, p. 40), determined that taxpayer's profit allowance was accruable in that year. Pointing to the absence of a "serious dispute" during negotiations and the fact that the parties

reached the settlement "with no visible discord," the majority of the Court of Claims predicated the accrual of income on the existence by the end of the taxable year of a reasonable expectation of settlement.

Dissenting Judge Whitaker agreed with the majority as to the basic principle controlling the time for accrual, and that the *Continental Tie & Lumber* case was not applicable. Judge Whitaker also agreed with the majority that a variable profit percentage rate to be determined by negotiation and settlement between the parties had to be resolved before the amount of income could be fixed. However, the dissenting Judge differed with the majority and agreed with taxpayer that until a final settlement had been reached which was binding on the parties, the amount to which taxpayer was entitled was not capable of being reasonably ascertained, and therefore not accruable. He pointed out that the profit rate tentatively agreed upon could have been revised at any time and that the amount of taxpayer's income could not be known until a binding settlement was reached. He also disagreed with the majority's statement that the tentative profit rate was not challenged by the Government in the year 1946, pointing out that this statement was directly contrary to the majority's finding 55.

While taxpayer is in accord with Judge Whitaker's interpretation of the findings of fact, this petition for certiorari is not predicated on the majority's erroneous application of its own findings. Taxpayer rests on the position taken by Judge Whitaker that the amount of its income under its claim for compensation for its terminated contracts was not fixed, determined or ascertainable and

therefore not accruable until a final settlement of its claim had been made which was binding on the parties.

Taxpayer contends that, as a matter of law, the majority applied an erroneous principle for the accrual of income resulting from a negotiated settlement of a claim against the Government. The majority of the Court of Claims held that this income accrued, not when the claim arose on termination of the taxpayer's contracts, as contended by the Government, and not when a final settlement fixing the amount of the income was made, as contended by taxpayer, but rather when the parties in their negotiations had reached a stage of sufficient agreement to provide a reasonable expectation of settlement. This novel theory of the Court below for the accrual of income from the settlement of unliquidated claims warrants review by this Court.

REASONS FOR GRANTING THE WRIT

1. The Court of Claims erroneously applied a subjective expectancy-of-settlement test for the accrual of income resulting from the settlement of an unliquidated claim for compensation for terminated Government contracts, contrary to the decisions of this Court and numerous lower courts. Taxpayer's profit allowance for its terminated Government contracts was determined by a negotiated settlement between taxpayer and the Navy Department. A binding final settlement was not reached until taxpayer's proposal for settlement had been approved by the Settlement Review Board of the Navy Department in 1946. Negotiations leading to this settlement

had begun between the taxpayer and the Government representatives promptly after termination of its contracts in 1945. The majority of the Court of Claims concluded as follows:

> "We think that under the facts and circumstances of this case, negotiations between the parties had reached a stage of sufficient agreement by the end of fiscal 1945 for the amount of plaintiff's profit allowance to be considered reasonably ascertainable at that time" (Appx. A, p. 40).

The Court also noted that there was an absence of "serious dispute" during negotiations, and that the negotiated settlement was reached with no "visible discord."[1] Thus, the court below applied purely subjective standards in determining the accrual of income from the settlement of taxpayer's terminated Government contracts. Accrual was not predicated by the court on identifiable events or on the use of objective tests. The decision of the court below is therefore contrary to decisions of this Court and of numerous lower courts which have uniformly applied objective standards in determining the existence of a fixed, determined and enforceable right to income, the prerequisites for accrual of income. Moreover, the decision of

[1] The Court of Claims distinguished this case from its decision in *Brezo Corporation v. United States*, 127 Ct.Cl. 261, 117 F.Supp. 404. In the *Brezo* case the taxpayer had a claim for compensation as a subcontractor due to termination of Government contracts. Rejecting the Government's contention that the income was accruable in the year of termination, the Court ruled that this income was accruable in the year of final settlement of its claim. The *Brezo* case was distinguished by the Court on the ground that there a serious dispute existed between the parties until the claim was settled, whereas in this case the Court stated that no serious dispute was present.

the Court of Claims is contrary to the well-established rule heretofore uniformly applied, that income from the settlement of an unliquidated claim for compensation is accruable in the year in which it is allowed, whether by final judicial determination or by final administrative action.[2]

U. S. Cartridge Co. v. U. S., 284 U.S. 511;
Lichtenberger-Ferguson Co. v. Welch, 54 F.2d 570, on remand, 14 F.Supp. 396;
Apex Electrical Manufacturing Co., 16 T.C. 1171, affirmed, 202 F.2d 151;
Globe Corporation, 20 T.C. 299, acq.;
Henry Hess Co., 16 T.C. 1363, affirmed, 210 F.2d 553;
Luckenbach Steamship Co., 9 T.C. 662, acq.;
Jamaica Water Supply Co., 42 B.T.A. 359, affirmed, 125 F.2d 512, certiorari denied, 316 U.S. 698;
H. Liebes & Co. v. Commissioner of Internal Revenue, 90 F.2d 932;
U.S. v. Safety Car Heating Co., 297 U.S. 88;
Mira Loma Flight Academy v. U.S., 55-2 USTC, par. 9612.

This rule had been uniformly applied by the Treasury Department in accruing income from cancelled Government contracts, until the promulgation of Mimeograph 5897. Prior to that time the Treasury Regulations provided that claims for compensation under cancelled Government con-

---

[2]In the case of *H. Liebes & Co. v. Commissioner of Internal Revenue*, 90 F.2d 932, a claim for compensation against the United States, which the taxpayer reduced to judgment which was not appealed, was held accruable in the year in which the time for appeal expired. The *Liebes* case was cited with approval both by the majority of the Court of Appeals for the Second Circuit and the dissenting judge in *Commissioner of Internal Revenue v. Fifth Avenue Coach Lines, Inc.*, 281 F.2d 556, certiorari applied for, Jan. 7, 1961.

tracts constituted income for the year in which they were allowed or their value was otherwise definitely determined. The Commissioner of Internal Revenue sought to provide an exception to this rule in the case of claims for compensation under terminated Government contracts covered by the Contract Settlement Act of 1944. Relying on the *Continental Tie & Lumber* case, the Commissioner ruled in Mimeograph 5897 that income in such cases accrued at the time of termination, and this ruling was embodied in the income tax regulations as an exception to the general rule stated above (see 17 N.Y.U. Institute on Federal Taxation, p. 191).

While the court below properly held the *Continental Tie & Lumber* case inapplicable, it nonetheless failed to apply the correct rule that income from the settlement of unliquidated claims for compensation from terminated Government contracts was accruable in the year in which the claims were allowed. Instead it applied neither the special rule invoked by the Government in the case of terminated war contracts, nor the generally accepted rule for accrual of income from cancelled Government contracts embodied in the regulations, but rather devised a rule of its own making based on accrual in the year in which there existed an expectancy of settlement.

Permitting this erroneous decision of the court below to stand would result in confusion in the accrual of income from the settlement of claims for terminated Government contracts.

2. Practical considerations call for the application of objective and definitive tests for the accrual of income arising from the settlement of claims for compensation

for terminated Government contracts. Tax accounting principles have been developed by this Court with a view to promoting certainty and uniformity in the administration of the Federal income tax laws. Accrual, whether of income or deductions, has not been permitted or required where the right to the income or the liability remained contingent.

Lucas v. American Code Co., 280 U.S. 445;
Brown v. Helvering, 291 U.S. 183;
Security Mills Co. v. Comm'r., 321 U.S. 281;
Spring City Co. v. Commissioner, 292 U.S. 182;
North American Oil v. Burnet, 286 U.S. 417.

In this case taxpayer's right to receive a profit allowance on its terminated contracts was not fixed by a binding final settlement until 1946. The use by the court below of a subjective expectancy-of-settlement test in holding that this income was accruable in the fiscal year 1945 would inject into tax accounting uncertainties and contingencies, both for taxpayer and the Government alike, that would impede the uniform and practical administration of the Federal income tax laws in situations of common occurrence. If income from the settlement of unliquidated claims for compensation from terminated Government contracts is treated as not accruable until a binding final settlement has been reached, certainty and uniformity in the accrual of such income would obtain. Such a rule would not permit recourse to hindsight, guesswork, or speculation.

The use of an objective test of accrual based on the identifiable event of a binding settlement would not admit of manipulation in establishing the year of accrual, such

as could be the case if the expectancy-of-settlement test applied by the court below were permitted to stand. In the Memorandum for Respondent filed in *Fifth Avenue Coach Lines, Inc. v. Commissioner* (S.Ct. No. 634, Oct. Term, 1960) at page 10 the Government stated, as the Court of Appeals for the Second Circuit had pointed out in that case, that "adoption of the subjective expectancy-of-appeal test advocated by taxpayer would permit litigants to choose the years of deductibility." So, too, the subjective expectancy-of-settlement test applied by the Court of Claims in this case would permit taxpayers to choose the years of accrual of income from settlement of terminated Government contracts. A taxpayer (or, as in this case, the Government) could always assert the presence or absence of a willingness to settle in an earlier year on the basis of settlement ultimately reached. Then, too, accruing income in the year of final settlement avoids any hardship to which taxpayers might be exposed in being subjected to a tax liability on income before the right to receive it has been finally fixed by a binding settlement. No matter how close the parties seemingly may be to settlement of a claim, it is not until a binding (not tentative) settlement has been reached that it can be said that income therefrom becomes fixed in any practical sense. The degree or absence of visible discord in the negotiations should not control accrual of income from settled claims.

The test for accrual adopted by the court below would involve all the uncertainty of an appraisal of the state of negotiations between the parties and speculation as to their probable outcome. This Court has refused to indulge in such speculation in the case of a settlement of a claim

for patent infringement (*U.S. v. Safety Car Heating Co.*, supra). Practical considerations dictate that when the right to income becomes fixed by a binding final settlement, only then should income be deemed accruable, regardless of the manner and the difficulty, or lack of difficulty, in reaching a settlement.

The sound administration of the revenue laws will be hindered by leaving undisturbed the decision of the court below, which applies an unworkable and impractical rule for the accrual of income from terminated Government contracts.

3. This case involves a principle of accrual of income from the settlement of terminated Government contracts which is of great importance to the revenue and of constant and continuing application.

Although this case relates to the settlement of terminated war contracts covered by the Contract Settlement Act of 1944 and the Joint Termination Regulation issued thereunder, essentially the same provisions governing the methods of settlement, measure of compensation, profit allowance and review by a settlement review board presently apply to military contracts terminated for the convenience of the Government.[3]

These provisions are contained in the Armed Services Procurement Regulations, 23 Federal Register 9221, promulgated pursuant to 5 U.S.C., section 22, and 10 U.S.C.,

[3]The uniform termination article required by §6(g) of the Contract Settlement Act is also required by ASPR §8.701. The same methods of settlement under JTR §513 also apply under ASPR §8.203 with settlement by negotiated agreement given primary emphasis in both. Fair compensation, the measure of compensation under §6 of the Contract Settlement Act, is also the measure under ASPR §8.300. The standards to be used in negotiating fair com-

section 2202. Thus, the same question presented in this case continues to arise in all cases of settlements of military contracts terminated for the convenience of the Government.

Not only is this question a continuing one, but it is one of great importance to the revenue. Government procurement still continues on a vast scale for military and national security purposes. With the constant reprograming and changing of procurement requirements large numbers of terminations of military contracts for the convenience of the Government continue to occur. The terminated contracts for which settlements must be made involve billions of dollars annually. The statistics covering terminations of military prime contracts for the fiscal period from July, 1959, to June, 1960, prepared by the Statistical Services Center of the Office of the Secretary of Defense are attached to this petition as Appendix C. Pages 6 and 7 of this pamphlet disclose that as of June 30, 1960, there were pending 1,538 military prime contracts terminated for the convenience of the Government which were in process of settlement and which involved an aggregate contract price of items terminated of $2,643,324,000. Over half of these contracts have been in process of settlement for a period of more than six months from the date of termination. During the fiscal year 1960, as shown by Table 1 on page 2 of this pamphlet, there were 5,546 terminations involving an aggregate contract price of

---

pensation under JTR §§531 and 532 are the same as those under ASPR §8.301. The allowance for profit under JTR §533 is the same as under ASPR §8.303. The requirement of review of settlements by a settlement review board under §6(c) of the Contract Settlement Act and JTR §582 and the scope of review and effect of action by the review board under JTR §§583 and 584 are the same as under ASPR §§8.211-2, 8.211-3 and 8.211-4.

$1,096,331,000. During said year there were 5,551 settlements of terminated contracts, involving a total contract price of $754,999,000.[4]

The magnitude of the revenues affected by the principle of accrual of income involved in this case is such as to demand review by this Court, to lay down the proper rule for the accrual of income from the settlement of terminated Government contracts.

During the current term this Court has granted certiorari in two income tax cases involving accrual. One case, *American Automobile Association v. United States*, 181 F.Supp. 255, certiorari granted, 364 U.S. 813, involves the year of accrual as income of prepaid membership dues received by an automobile club. The other case is *Consolidated Edison Co. of New York v. United States*, 279 F.2d 152, certiorari granted, 364 U.S. 890, involving the accrual of a deduction for the payment under protest of disputed real property taxes. The tax accounting question involved in this case bears only a general relationship to the problems involved in those two cases. It is not believed that the decisions in those cases will be dispositive of the question of accrual of income from settlement of termi-

---

[4]The above-published statistics referred to relate only to terminated military prime contracts. No statistics are available to the taxpayer covering the number or amount of the contract price of military subcontracts or nonmilitary contracts terminated for the convenience of the Government. In this case taxpayer's terminated prime contracts resulted in the termination of subcontracts for between 1,500 to 2,000 subcontractors, involving an aggregate settlement of approximately $16,700,000 (Tr. p. 17, Stip. Exh. F). Taxpayer is informed and believes that numerous nonmilitary Government contracts such as those administered by the National Aeronautics and Space Administration in connection with the programs for the exploration of outer space, involving large sums of money, have been and are being terminated for the convenience of the Government.

nated Government contracts involved in this case. The two accrual cases now awaiting decision by this Court are adverted to because certiorari was granted apparently in recognition of the large number of taxpayers or large amounts of revenue affected by the principle of accrual there involved. It is submitted that the accrual question presented in this case is of far greater magnitude, both as to numbers of taxpayers and as to amounts of revenue affected.

Review should be granted so that this Court can resolve the conflict created by the decision of the Court of Claims and prescribe the proper rule for accrual of compensation from the settlement of terminated Government contracts.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be granted.

Dated, May 25, 1961.

Respectfully submitted,

HARRY R. HORROW,
Attorney for Plaintiff.

ROBERT W. MORRISON,
PILLSBURY, MADISON & SUTRO,
Of Counsel.

(Appendices A, B and C Follow.)

Appendix A

IN THE

United States Court of Claims

No. 147-54

(Decided December 1, 1960)

FOOD MACHINERY AND CHEMICAL CORPORATION, A CORPORATION, v. THE UNITED STATES

Harry R. Horton for the plaintiff. *Robert W. Morrison* and *Pillsbury, Madison & Sutro* on the briefs.

Jerome S. Hertz, with whom was *Assistant Attorney General Charles K. Rice*, for the defendant. *James P. Garland* and *Philip R. Miller* on the brief.

LITTLETON, *Judge* (*Ret.*), delivered the opinion of the court:

Plaintiff, an accrual basis taxpayer, sues to recover income and excess profits taxes paid for its fiscal year ended September 30, 1945 (hereinafter called fiscal 1945). The taxes in question, in the amount of $744,548.35, were paid upon a profit allowance of $906,621.81 received by plaintiff on a contract termination claim which was actually paid in 1946 and 1947. The issue in the case is whether plaintiff was properly required by the Commissioner of Internal Revenue to accrue this sum as income for fiscal 1945, when its contract was terminated. Plaintiff claims the sum was not properly accruable until 1946.

It is clear that if, in fiscal 1945, plaintiff had a fixed right to receive a reasonably ascertainable amount as a

profit allowance, that amount was properly accruable in that year. *Continental Tie and Lumber Co. v. United States*, 286 U.S. 290. When books of account are kept, and tax returns prepared, on the accrual, rather than cash, basis, the time when a right to receive or a liability to pay an ascertainable amount becomes fixed, and not the time of actual receipt or payment, is decisive of the proper time for accrual. *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 184-5; *Security Mills Co. v. Commissioner*, 321 U.S. 281.

The question here, therefore, is whether in fiscal 1945 plaintiff's right to receive payment on its termination claim was a fixed right to receive a reasonably ascertainable amount.

Plaintiff, a Delaware corporation with its principal office at San Jose, California, was engaged in the manufacture of amphibian tanks and spare parts under fixed-price contracts with the Department of the Navy during World War II.

The eleven contracts involved in this case were entered into between plaintiff and the United States Navy's Bureau of Ships from November 1943 to July 1945. They were all war contracts within the coverage of the Contract Settlement Act of 1944, 58 Stat. 649, 41 U.S.C. § 101, and of the Joint Termination Regulation, as amended.[1]

Eight of the contracts contained termination clauses providing for fair compensation, including a profit allowance, to be paid to plaintiff in the event the contracts

---

[1] 9 F.R. 13316; 10 F.R. 10793, 13189; 11 F.R. 28, 1728, 4226, 6295, 11479.

were terminated for the convenience of the Government. The parties were to attempt to negotiate the amount of the profit allowance, but if no agreement could be reached, plaintiff was to receive a profit equal to 2% of the cost of material purchased by plaintiff but not yet processed, plus 8% of the cost of work in progress, but not more than 6% of the total of the above costs. Plaintiff's records indicated what material was purchased for each contract, but items common to several contracts were physically commingled. As work in process, plaintiff's books showed labor, burden and raw materials fabricated by plaintiff, but not material furnished by plaintiff to its subcontractors, or purchased components and material, which plaintiff placed in the finished goods account when items were completed. At any given time, only a physical count, and not plaintiff's records, could have disclosed the actual work in process. No effort was made by plaintiff to determine the actual amount of work in process on the contracts here involved.

Plaintiff's eleven contracts were terminated under the provisions of the Contract Settlement Act of 1944 and the Joint Termination Regulation, by termination notices issued between July 20 and August 30, 1945.

Plaintiff had become aware, early in 1945, that its contracts might be terminated. On June 20 and 21 and during the week of July 2, pretermination conferences were held between plaintiff's representatives and representatives of the Bureau of Ships, headed by Captain Rosenstein, the contracting officer in charge of plaintiff's contracts. The parties discussed means of calculating costs due to cancellation, the manner of counting and classification, pres-

ervation and disposal of inventories, the rate of profit plaintiff was to receive, and the approximate amounts involved. Plaintiff proposed a 6.4% rate of profit; the Navy offered the terms generally used by it of 3% on materials and purchased parts and 10% on work in process. Plaintiff's estimate of work in process as at least 25% of its inventories would have yielded an overall rate of 4.75% at the Navy's terms. Discussion led to an oral agreement on a profit rate of 4.875%, upon which basis plaintiff would submit its termination claims.

On July 19, 1945, the Bureau of Ships submitted to plaintiff a draft pretermination agreement referring to five of plaintiff's contracts. The draft provided a 4.875% rate of profit which was to include packing expenses, and contained extensive provisions relating to inventories, classification of items and pricing of materials.

Plaintiff did not reply formally to the July 19 proposal and no pretermination agreement was executed, for the war had ended and the contracts were terminated. Plaintiff's post-termination activities proceeded under the Joint Termination Regulation.

When plaintiff received the termination notices, work was stopped, suppliers and subcontractors notified to stop work, and preparations for inventory counts made. Work in process then on feed lines of subcontractors and subassembly lines of plaintiff's largest plants was reviewed with Navy representatives and disposition of some of this material was determined. Subassemblies not used as such in spare parts were disassembled and their parts returned to stock bins. Semifabricated pieces were scrapped, and materials in process returned to stock bins. The return

of parts and materials to the bins was with the approval of the Navy.

Under the circumstances, when plaintiff's inventory was taken, it was not possible to distinguish between purchased parts and raw materials on the one hand and work in process on the other.

On August 29, 1945, plaintiff asked to be permitted to file two joint inventory and settlement proposals, each covering four of the terminated contracts. Captain Rosenstein, by letter of September 21, 1945, approved plaintiff's request.

At a meeting on September 18, 1945, plaintiff's president and Captain Rosenstein reached an understanding that the 4.875% profit rate remained mutually agreeable and would be claimed by plaintiff and allowed by Captain Rosenstein. Captain Rosenstein's letter of September 21 confirmed this understanding. It was also understood that the rate of profit was subject to review by the Government's Settlement Review Board in Washington, D.C.

This, then, is the stage to which matters had progressed when plaintiff's fiscal year came to an end on September 30, 1945.

On November 12, 1945, plaintiff requested permission to consolidate some of its termination claims, setting August 17, 1945, as consolidated termination date. Three days later, it asked to be permitted to submit one settlement proposal covering all its terminated contracts, apportioning charges *pro rata*. This requested procedure was authorized verbally by Captain Rosenstein on or about November 26, which authorization was confirmed by the Supervisor of Shipbuilding by letter dated December 7.

On November 27 plaintiff filed its first settlement proposal. The claim stated a total inventory of metals, purchased parts, finished components and work in process of $18,618,592.43. Applying the 4.875% rate of profit, plaintiff claimed a profit of $907,656.38.

The claim was received by the Bureau of Ships' Contract Termination Section in Washington on or about January 3, 1946. With the claim was a report dated December 14, 1945, by the Navy's Supervisor of Shipbuilding responsible for plaintiff's contracts. The report stated that Navy personnel had examined the inventories and checked prices, finding materials in good condition and properly allocable to the terminated contracts. The report did refer to such questionable items in the claim as plaintiff's failure to deduct cash discounts from costs. Since plaintiff waived other items of cost which it might have claimed, no adjustment was required. The report also noted that the requested profit was based on the rate agreed upon at the meeting of September 18, 1945, although purchased parts constituted a larger percentage of total inventories than appears to have been anticipated during the negotiations about profit rate.

At a meeting on January 8, 1946, between representatives of plaintiff and of the Navy, plaintiff was asked to apply for partial payment of its claim. Although plaintiff refused to apply, partial payment in the amount of $18,500,000, representing approximately 95% of plaintiff's total claim was received, approved, and paid to plaintiff's president on January 10. The amount paid was less than the sum claimed for inventories and did not represent any allowance for profit or disposal credits.

At the January 8 meeting, plaintiff was also asked to supply material which would explain the variation between the estimated figure of 25% representing work in process and the 7% reflected in plaintiff's claim filed November 27, 1945. In a letter dated February 13, 1946, plaintiff pointed out that it had included as work in process only such items as were unquestionably that, while much work which could properly have been included was omitted due to the impossibility of segregating and identifying it. Plaintiff noted additional items which would have been properly classified as work in process but which had not been so classified, and also agreed to waive certain substantial items of cost.

On March 26, 1946, Captain Rosenstein submitted to the Settlement Review Board written proposals for settlement of plaintiff's claim. Except for freight charges in the amount of $21,222, Captain Rosenstein recommended approval of plaintiff's claim as submitted. This exception reduced the profit allowance to $906,621.81. The Board's approval was given on March 27, and its action was in turn approved by the Chief of the Bureau of Ships.

On April 11, the Navy submitted to plaintiff for execution two supplemental agreements covering plaintiff's termination claim as approved, and plaintiff returned executed copies on May 21. Payments of the amounts due on these contracts, less the $18,500,000 already paid on January 10, were made to plaintiff on June 12 and 13, together with interest from the date of the agreements to the date of payment.

These two agreements, pursuant to the claim filed November 27, 1945, covered only plaintiff's own claim, and

did not include subcontractors' termination claims or settlement expenses incurred by plaintiff after October 1, 1945. Between November 27, 1945, and October 22, 1946, plaintiff submitted ten additional claims, which covered these additional claims and expenses.

The tenth interim settlement proposal, submitted on September 9, 1946, included a claim for settlement expenses incurred by plaintiff since October 1, 1945, totaling $590,077.65.

Plaintiff's twelfth and final settlement proposal was submitted to the Navy on October 22, 1946. Final disposition of plaintiff's claims was made on the basis of this proposal. The total of plaintiff's previously allowed inventories of metals, purchased parts, finished components and work in process was $18,597,370.43. A profit of 4.875% thereon totaling $906,621.81, as allowed on plaintiff's first claim, was included. This produced a total of $19,503,992.24. After a deduction of $283,841.87 for disposal credits, a balance to be claimed of $19,220,150.37 remained. Various interest charges totaling $160,745.10 were added, as was an allowance of $590,077.65 for settlement expenses, as set forth in the tenth interim proposal.

On November 19, the Bureau of Ships' contracting officer recommended approval of the final proposal, and the Settlement Review Board approved it on November 26. Final settlement was approved by the Chief of the Bureau of Ships. Execution of the final contracts and final payment to plaintiff of the balance due it were completed by January 9, 1947.

The $906,621.81 allowed to plaintiff as profit on its terminated contracts was included in plaintiff's ordinary net

income, surtax net income and excess profit net income for its taxable year ending September 30, 1945. Plaintiff filed a timely claim for refund of income and excess profits taxes in the amount of $652,767.67 for that year, on the grounds that the $906,621.81 profit was not properly includible in that year's income. The Commissioner of Internal Revenue disallowed plaintiff's claim on April 24, 1952, and plaintiff's petition was timely filed in this court on April 8, 1954.

It is in light of these facts and circumstances that we must determine whether plaintiff's right to receive termination payment from the Government was fixed in fact and in amount in its taxable year ending September 30, 1945.

There is no dispute between the parties as to the fact of plaintiff's right, in 1945, to receive some payment from the Government. The parties differ on the question of whether this right was sufficiently fixed in amount.

Plaintiff says that the right to receive a profit allowance was not reasonably ascertainable in amount until 1946, when its termination claims were settled. It argues that although the Contract Settlement Act gave it the right to fair compensation for termination of its contracts, the Act did not establish a right to receive any ascertainable amount.

Defendant maintains that the amount payable to plaintiff was readily ascertainable from its books and records as of the close of its taxable year. Defendant says that plaintiff had both a contract and a statutory right to fair compensation, including profits, for work undertaken prior to the date of termination. While the contracts and the

Contract Settlement Act provided that negotiated settlements should be attempted, those contracts which contained the Uniform Termination article specified that, if agreement could not be reached, plaintiff was entitled to a profit allowance of 2% of the cost of purchased articles or materials, plus 8% of the cost of work in process, not to exceed 6% of total costs.

Section 6 of the Act, 41 U.S.C. § 106, requires contracting agencies to provide speedy and fair compensation for termination of war contracts. 41 U.S.C. § 106(a). Each agency is required to establish methods and standards for determining fair compensation

> on the basis of actual, standard, average or estimated costs, or of a percentage of the contract price based on the established percentage of completion of work under the terminated contract, or on any other equitable basis, as it deems appropriate. 41 U.S.C. § 106(b).

Such methods and standards are to take into account certain specified items of cost, 41 U.S.C. §106(d)(1)-(7), and to exclude others, § 106(d)(i)-(iv).

The agency may settle a termination claim by agreement with the contractor, or by unilateral determination of the amount due on the claim, or by a combination of both methods. 41 U.S.C. § 106(e). No settlement providing payment of more than $50,000 is to be binding on the Government until reviewed and approved by a Settlement Review Board. 41 U.S.C. § 106(e). Claims are to be settled by agreement to the maximum extent feasible. 41 U.S.C. § 106(e).

Plaintiff argues that, far from establishing definite and precise standards for determining fair compensation, the

Act gives Government agencies broad discretion in settling termination claims. Plaintiff says that the amount of compensation to which it was entitled could not be determined from an examination of the Act, nor even from an examination of plaintiff's books and records, and that the amount of compensation could not be known until a negotiated settlement of plaintiff's claims had been reached.

As we have said, plaintiff does not deny that it had a right to receive *something*, but it says that the amount remained in doubt at the close of fiscal 1945. Plaintiff says that the following factors rendered doubtful the amount it was to receive: the Contract Settlement Act did not provide any formula for determining fair compensation; questions concerning the form of plaintiff's claims and the method of allocating items among the various contracts had not been settled; difficulties in classifying plaintiff's inventories as raw materials, purchased parts or work in process and in determining allowable costs, led to uncertainty in the calculation of a proper profit allowance; in any event, the amount of the profit allowance was not fixed until approved by the Navy's Settlement Review Board and the chief of the Bureau of Ships.

Continental Tie and Lumber Co. v. *United States*, 286 U.S. 290, is said by defendant to be controlling here. In that case, an accrual basis taxpayer challenged the Commissioner of Internal Revenue's inclusion of the amount of an award of the Interstate Commerce Commission under § 204 of the Transportation Act of 1920, 41 Stat. 456, 460, as income for the year in which the Act was

passed, rather than the year in which the amount of the award was determined and paid.

The Supreme Court stated that the problem presented in the *Continental Tie* case was

> whether the taxpayer had in its own books and accounts data to which it could apply the calculations required by the statute and ascertain the *quantum* of the award within reasonable limits. 286 U.S. at 296.

§ 204 of the Transportation Act provided for an award and payment to a railroad which, during a period of federal control of some railroads at the time of the first world war, had operated its own road but had competed for traffic with a railroad which had been under federal control, and had sustained a deficit in operating income during the time when it operated its own railroad.

The Interstate Commerce Commission was to compare the results of the railroad's operation during the period of federal control with those during a defined test period, and, if the results for the period of federal control were less favorable, to make an award in an amount calculated in the manner prescribed by the section.

The Transportation Act became effective February 28, 1920, and on June 10 the Interstate Commerce Commission issued general instructions for carrying § 204 into effect. The award and payment were made to the taxpayer in 1923, and the taxpayer claimed that the sum should be deemed income in that year, rather than in 1920, because the amount depended upon so many contingencies that no reasonable estimate thereof could have been made in 1920.

The Court held the amount properly accruable in 1920, stating:

> the function of the Commission under the act was ministerial, to ascertain the facts with respect to the carrier's operating income by a comparison of the experience during the test period with that during the term of federal control. The right of the award was fixed by the passage of the Transportation Act. What remained was mere administrative procedure to ascertain the amount to be paid. Petitioner's right to payment ripened when the act became law. 286 U.S. at 295.

The Court went on to point out that the railroad kept its accounts according to standards prescribed by the Interstate Commerce Commission, and that these accounts were the source of the information on which the amount of the award would be based. Although general principles for the determination of relevant factors had been formulated by the Act, there were questions of fact to be resolved by the exercise of opinion and judgment. The Court pointed to the presence of questions concerning the time for closing out reserve accounts, the allocation to the period in question of sums expended for maintenance, the price at which renewals and replacements should be charged in view of rising costs, and the allowance to be made for differing efficiency of labor in the two relevant periods. These questions seem quite similar to the questions concerning allocation of costs, subcontract charges, and inventories, and concerning an effective termination date, which existed in this case at the close of the taxable year in question.

Despite the existence of these questions, the Court thought that

> it was possible for a carrier to ascertain with reasonable accuracy the amount of the award to be paid by the Government. Subsequent to its order of June 10, 1920, the [Interstate Commerce] Commission made no amendment or alteration of the rules with respect to the information to be furnished under § 204. Obviously the data had to be obtained from the railway's books and accounts and from entries therein all made prior to March 1, 1920. These accounts contained all the information that could ever be available touching relevant expenditures. 286 U.S. at 297.

We think, therefore, that, under the reasoning of the *Continental Tie* case, the cost and inventory figures, which were to constitute a part of the basis for calculating plaintiff's profit allowance, were ascertainable within reasonable limits during the taxable year in question.

However, in this case, the amount which would be paid to plaintiff did not depend solely upon the cost and inventory figures contained in its books and accounts, or upon quantities which could be reasonably calculated on the basis of those figures and upon physical inventories on hand. Under the Contract Settlement Act of 1944, the rate of profit to be allowed was left for negotiation by the parties. It was to be a figure which would provide "fair compensation" to the contractor. While the questions in this case as to the amounts of cost and inventory items were quite similar to the questions which existed in *Continental Tie* as to the calculation of certain factors, the difference between the cases lies in the fact that, under

the Transportation Act, once such calculations were made, the amount of the award was established, while under the Contract Settlement Act, after the determination of cost and inventory figures has been made, there still remains for determination a factor which is not established by the Act, that is, the rate of profit to be allowed upon the cost and inventory figures. Thus, under the Contract Settlement Act, the taxpayer's books and accounts and inventories do not contain *all* the material, however debatable its treatment may be, relevant to a determination of the amount which it will receive, as they do under the Transportation Act.

We must, then, consider whether the rate of profit which plaintiff was to receive had been sufficiently established prior to the close of fiscal 1945 to permit plaintiff's profit allowance to be reasonably ascertained. Plaintiff says that the rate of profit was not fixed until it was approved by the Settlement Review Board, as required by § 6(c) of the Contract Settlement Act and paragraph 582.1 of the Joint Termination Regulation. Approval by the Settlement Review Board did not take place until March 27, 1946. We think, however, that final, formal approval of the proposed settlement was not necessary to give it sufficient definiteness in amount. Under paragraph 503(a) of the Joint Termination Regulation, the "sole function of the settlement review board is to determine the overall reasonableness of the proposed settlement from the standpoint of protecting the Government's interest." The substance of the settlement proposal was to be and in this case had been worked out between the contractor and the Government's contracting officer. Their agreement,

reached with no visible discord, and giving rise to no apparent question as to over-all reasonableness, established plaintiff's right in a reasonably ascertainable amount. We do not think that lack of formal approval by the Settlement Review Board deprives the amount of sufficient certainty any more than lack of the action by the Interstate Commerce Commission in making an award to the railroad, which action was admittedly necessary before any payment could be made, affected the railroad's right in the *Continental Tie* case. See also *Commissioner of Internal Revenue v. Dumari Textile Co.*, 142 F.2d 187, at 899-900, 47 B.T.A. 639, at 646.

Plaintiff says that it was not until the completion of negotiations between it and the Navy some time 1946 that the amount of profit allowance was determi . . The Navy's contracting officer did not submit plaintiff's proposal to the Settlement Review Board for approval until March 26, 1946. Plaintiff says that this is because he had been awaiting the February 13 letter from plaintiff justifying the claimed rate of profit, which had been questioned at the January 8 meeting.

We note, however, that a profit rate of 4.875% had been first suggested and tentatively agreed upon in the course of the pretermination conferences which took place in June and early July of 1945. Defendant's representatives prepared, and submitted to plaintiff on July 19, a draft of a pretermination agreement incorporating the 4.875% profit rate. While this draft was not in final form and did not bind the parties, and in fact no pretermination agreement was ever entered into between the parties, representatives of the parties met, after termination of the contracts, on September 18 and concluded that the

4.875% profit rate previously agreed upon remained mutually agreeable. The Government contracting officer's letter of September 21 to plaintiff stated:

> the Contracting Officer on behalf of the Bureau of Ships, and Mr. Davies on behalf of the Contractor, agreed that this profit figure of 4.875%, which had previously been agreed upon for purposes of the pre-termination agreement, was mutually agreeable and would be claimed and allowed in the termination claims submitted by the Contractor under the subject contracts.

It is true that plaintiff did not actually submit its first termination claim until November 27, 1945, and that in January 1946 the contracting officer requested information from plaintiff in support of its claim. No challenge to the profit rate was made; the purpose of the contracting officer's request for material justifying the profit rate appears to have been to have available in the record an explanation of why the plaintiff's accounts reflected work in process of only 7%, whereas the profit rate agreed upon was predicated upon work in process somewhat in excess of 25%. The record does not show that any suggestion was made that the profit rate be reconsidered after September 30, 1945, nor that the profit rate was in fact reconsidered at any time. Plaintiff asserts that even if the rate of profit was sufficiently settled, no specific amount representing the costs to be allowed, to which the rate of profit was to be applied, had been mentioned or agreed upon by the parties. We think, however, that the teaching of the *Continental Tie* case is that no specific amount need be mentioned, as long as the information relevant to determination of the amount is available. We think that information was available in this case.

We think that under the facts and circumstances of this case, negotiations between the parties had reached a stage of sufficient agreement by the end of fiscal 1945 for the amount of plaintiff's profit allowance to be considered reasonably ascertainable at that time.

Plaintiff's principal reliance is on two cases, *Breeze Corporations, Inc. v. United States*, 127 Ct. Cl. 261, 117 F.Supp. 404, and *Apex Electrical Mfg. Co.*, 16 T.C. 1171, affirmed *per curiam*, 202 F.2d 151 (6 Cir.).

In the *Breeze* case, an accrual basis taxpayer, a second tier subcontractor under war contracts which were terminated in 1945, had included in its tax returns for 1945 an item of some $75,000, representing an amount it believed would be due to it from the first tier subcontractor on the terminated portions of its contracts. The taxpayer subsequently claimed that its accrual of the $75,000 in 1945 had been erroneous because it had no fixed right to that or any reasonably ascertainable amount during the year 1945.

The $75,000 represented the estimated value of certain pumps which were manufactured by the taxpayer. The taxpayer was engaged in manufacturing pumps of the kind in question under a prime contract with the Navy as well as under its subcontract, and there was a question as to whether the pumps were properly allocable to the subcontract or to the prime contract. The Government claimed that because the first tier subcontractor had not denied the claim in 1945, the taxpayer had a fixed right to payment in that year.

The court noted, however, that the taxpayer's estimate of inventory applicable to the terminated contracts had

not been approved or allowed in 1945 either as to its value or as to its allocability to the terminated contracts. The court found that voluminous correspondence, many conferences and partial settlement agreements, a complete denial of the claim at one time and negotiations continued for several years resulting in a settlement for one-third of the original claim sufficiently demonstrated "there was a serious dispute as to whether any or all of the pumps were allocable to the terminated contracts." 127 Ct. Cl. at 272. The court concluded, therefore, that it was "apparent both the right to recover payment and the amount, if any, payable remained uncertain until settlement of the dispute in 1949." 127 Ct. Cl. at 273.

Here there was no "serious dispute" as to allocation of any items of inventory. Though there would have been substantial difficulty in physically separating materials from work in process here, the necessity for so doing had been obviated by the agreement at an early stage in the negotiations that the profit allowance would not be based upon different precentages of the costs of materials and work in process, but rather upon an agreed-upon percentage of total costs. In *Breeze* the parties at the close of the taxable year in question stood in conflict as to the allocation of the pumps; in the case at bar the only matters undetermined at the close of fiscal 1945 were of the nature of those described by the Supreme Court in *Continental Tie* as not making it impossible to determine with reasonable accuracy the amount of the payment to be made by the Government. 286 U.S. at 297.

The *Apex Electrical Mfg. Co.* case, 16 T.C. 1171, is of no help to plaintiff, since in that case the fact of lia-

bility itself was denied during the taxable year in issue, and the court found that there had been no fixed right to receive *any* amount.

Globe Corporation, 20 T.C. 299, also relied on by plaintiff, is not helpful either, since, although the taxpayer there, in the taxable year in question, did, as plaintiff says, have a right to receive fair compensation, the negotiations between the parties had not in that year reached any agreement, however tentative, on the amount, or method, of computing the amount of fair compensation.

We have carefully examined all of the other cases cited by plaintiff, but it is clear that they do not support plaintiff's position in this case, and they do not warrant discussion.

Plaintiff is not entitled to recover, and its petition will be dismissed.

It is so ordered.

LARAMORE, *Judge*; MADDEN, *Judge*; and JONES, *Chief Judge*, concur.

WHITAKER, *Judge*, dissenting:

I regret that I am unable to agree with the opinion of the majority.

That opinion correctly says that "the time when a right to receive or a liability to pay an ascertainable amount becomes fixed * * * is decisive of the proper time for accrual"; but I disagree with the statement that the amount of plaintiff's profit was ascertainable in the fiscal year ending in 1945.

The contracting officer had agreed with plaintiff that its profit should be a certain percentage of the cost of

the work done, but this was subject to approval by the Settlement Review Board. On review, the contracting officer's superiors in Washington demanded an explanation of the difference between the estimated figure of work in process of 25 percent, on which the agreed percentage of profit had been based, and the actual figure of 7 percent. Most of the contracts provided for a profit, in the absence of an agreement, of 2 percent of the cost of materials purchased, but not in process, plus 8 percent of the cost of work in process. The profit agreed on between plaintiff and the contracting officer was based on the estimate that 25 percent of work was in process. It was not until after this variance between the estimate of work in process and the actual amount had been explained that the Settlement Review Board approved the rate of profit tentatively agreed upon. This was on March 27, 1946, long after the close of the fiscal year ending in 1945.

It was impossible to ascertain the amount of plaintiff's profit until the rate or percentage to be used in computing it was known.

The fact that the rate of profit was not determined prior to September 30, 1945, is an essential difference between this case and *Continental Tie and Lumber Co. v. United States*, 286 U.S. 290.

In *Continental Tie* only two factors had to be considered in determining the amount of the award: (1) income figures derived from the books of the plaintiff, and (2) the calculations required by section 204 of the Transportation Act of 1920, 41 Stat. 456, 460. Under that Act these two factors were fixed, with nothing left to

be done except the ministerial act of computing the award. No action of either party could have varied these factors; hence, no action of either party could have varied the amount of the award. Not so in the present case. Although the cost figures might have been reasonably ascertainable from plaintiff's books, there was no statutory formula nor an agreed percentage to apply to these figures. On the contrary, there was a variable profit percentage rate to be determined by negotiation and settlement between the parties, if possible. Therefore, unless a settlement had been reached, which was binding on the parties, or it was definitely determined that none could be reached, it cannot be said that the amount to which plaintiff was entitled was capable of being reasonably ascertained. The profit rate tentatively agreed upon could have been revised prior to September 30, 1945, and, hence, the amount of the award was not known prior to that date. As pointed out above, this was not the case in *Continental Tie;* therefore, that case is not controlling.

In the opinion of the majority, it is stated that the tentative profit rate was not challenged. This is erroneous. In finding 35, it is said that at the January 8, 1946 meeting, the reasonableness of the 4.875 percent rate was questioned, because it had been predicated on an estimate of the percentage of plaintiff's inventory consisting of work in process which was at variance with the percentage shown in plaintiff's settlement proposal. If plaintiff had been unable to explain the discrepancy, in all probability defendant would have found the 4.875 percent rate unreasonable, and would not have approved it.

For the reasons stated, I respectfully dissent.

Findings of Fact

The court, having considered the evidence, the report of Commissioner Roald A. Hogenson, and the briefs and argument of counsel, makes findings of fact as follows:

1. Plaintiff is and was a Delaware corporation, being the surviving corporation in a statutory merger of Food Machinery Corporation and Westvaco Chemical Corporation. Reference to plaintiff includes the predecessor Food Machinery Corporation. Plaintiff's principal office is and was at San Jose, California.

2. The taxes involved in this case are corporate income and excess profits taxes paid by plaintiff to defendant for its fiscal year beginning October 1, 1944, and ending September 30, 1945. Its tax returns for this year were due on December 15, 1945, but plaintiff requested and was granted extensions of time and actually filed the returns on May 17, 1946, with the Collector of Internal Revenue for the First District of California. Plaintiff's books of account are and were maintained on the accrual method of accounting, and its returns were prepared accordingly.

3. During the tax year ended September 30, 1945, in addition to its other activities, plaintiff was engaged in the manufacture of amphibian tanks (Landing Vehicles Tracked) and spare parts under contracts with the Navy Department. Before plaintiff had completed performance, certain of its contracts were fully or partially terminated by action of the Navy. These uncompleted contracts so terminated, together with a description of the contract, the original amount of contract, the date of termination notice and the extent of termination, were as follows:

Date of contract	Contract NObs.	Description of contract	Amount of contract	Date of termination notice	Extent of termination
11/21/43	1394 (Supplement).	Amphibian tractor spare parts.	$126,448,846	3/7/45 7/20/45 as amended 8/13/45.	Partial. Partial.
6/13/44	1666	Amphibian tractor spare parts.	27,854,250	8/14/45	Partial.
12/11/44	2011	Field modification kits.	1,867,461	8/13/45	Partial.
12/15/44	2017	Amphibian tractors	6,570,250	3/7/45 7/20/45 as amended 8/30/45.	Partial. Complete.
12/15/44	2018	Amphibian tractors	39,711,000	8/13/45 as amended 8/17/45.	Partial.
5/ 4/45	2155	Amphibian tractors	3,822,000	8/13/45 as amended 8/17/45.	Complete.
5/22/45	2166	Amphibian tractors (material for light weight).	3,700,000	8/13/45	Complete.
12/14/44	22163	Amphibian tractor spare parts.	80,000	8/13/45	Partial.
7/14/45	22512	Fuel cell assemblies	207,750	8/30/45	Partial.
5/25/45	23180	Final drive kits	3,110,035	8/17/45	Complete.
7/13/45	31131	Bow gun locks	8,107	8/24/45	Complete.

Under the column "Extent of Termination", the term "Partial" means that some deliveries had been made on the listed contracts prior to termination, whereas "Complete" means that no deliveries had been made and that termination canceled the entire contract.

Of the above-listed contracts, all except Nos. 2166, 23180, and 31131 contained the Uniform Termination Article. That article, as taken from contract No. 22512, provided (in the absence of an agreed termination settlement):

> (d) In the event of the failure of the Contractor and contracting officer to agree as provided in the

paragraph (c) upon the whole amount to be paid to the Contractor by reason of the termination of work pursuant to this section, the Government, but without duplication of any amounts agreed upon in accordance with paragraph (c), shall pay to the Contractor the following amounts:

(1) For completed articles delivered to and accepted by the Government (or sold or retained as provided in paragraph (b)(7) above) and not theretofore paid for, forthwith a sum equivalent to the aggregate price for such articles computed in accordance with the price or prices specified in the contract;

(2) In respect of the contract work terminated as permitted by this section, the total (without duplication of any items) of (i) the cost of such work exclusive of any cost attributable to articles paid or to be paid for under paragraph (d)(1) hereof; (ii) the cost of settling and paying claims arising out of the termination of work under subcontracts or orders as provided in paragraph (b)(5) above, exclusive of the amounts paid or payable on account of supplies or materials delivered or services furnished by the subcontractor prior to the effective date of the notice of termination of work under this contract which amounts shall be included in the cost on account of which payment is made under subdivision (i) above; and (iii) a sum equal to 2 percent of the part of the amount determined under subdivision (i) which represents the cost of articles or materials not processed by the Contractor, plus a sum equal to 8 percent of the remainder of such amount, but the aggregate of such sums shall not exceed 6 percent of the whole of the amount determined under subdivision (i), which for the purpose of this subdivision (iii) shall exclude any charges for interest on borrowings;

(3) The reasonable cost of the preservation and protection of property incurred pursuant to paragraph (b)(9) hereof: and any other reasonable cost incidental to termination of work under this contract, including expense incidental to the determination of the amount due to the Contractor as the result of the termination of work under this contract.

The total sum to be paid to the Contractor under subdivisions (1) and (2) of this paragraph (d) shall not exceed the total contract price reduced by the amount of payments otherwise made and by the contract price of work not terminated. Except for normal spoilage and to the extent that the Government shall have otherwise expressly assumed the risk of loss, there shall be excluded from the amounts payable to the Contractor as provided in paragraph (d)(1) and paragraph (d)(2)(i), all amounts allocable to or payable in respect of property which is destroyed, lost, stolen, or damaged so as to become undeliverable prior to the transfer of title to the Government or to a buyer pursuant to paragraph (b)(7) or prior to the sixtieth day after delivery to the Government of an inventory covering such property, whichever shall first occur.

• • • • •

(h) For the purposes of paragraphs (d)(2) and (d)(3) hereof, the amounts of the payments to be made by the Government to the Contractor shall be determined in accordance with the Statement of Principles for Determination of Costs upon Termination of Government Fixed Price Supply Contracts approved by the Joint Contract Termination Board, December 31, 1943. The Contractor for a period of 3 years after final settlement under the contract shall make available to the Government at all reasonable times at the office of the Contractor all of its books,

records, documents, and other evidence bearing on the costs and expenses of the Contractor under the contract and in respect of the termination of work thereunder.

4. All of the contracts listed in finding 3 were war contracts as defined by, and were terminated under, the provisions of the Contract Settlement Act of 1944, enacted July 1, 1944, 58 Stat. 649, 41 U.S.C. 101, and the Joint Termination Regulation, as amended, issued pursuant thereto by the War and Navy Departments, 9 F.R. 13316; 10 F.R. 10793, 13189; 11 F.R. 28, 1728, 4226, 6295, 11479.

5. During the pertinent period of time, plaintiff's Procurement and Engineering Division, located in Los Angeles, was responsible for the administration of plaintiff's war contracts. It was an engineering and administrative group which performed all the engineering functions, made practically all purchases and procurement, let out most subcontracts, scheduled all work, and approved all invoices for payment.

6. Prime manufacturing under plaintiff's war contracts was carried on by plaintiff's Anderson-Barngrover Division at San Jose, California, its Riverside Division at Riverside, California, and its Lakeland Division at Lakeland, Florida.

7. Plaintiff kept a full set of records with respect to cost and performance. These records indicated what material was purchased for each contract. However, because common items were involved, material involved in the performance of more than one contract was physically commingled and not segregated or earmarked for a particular contract. Common items for more than one contract were often purchased on a single purchase order.

8. With respect to work in process, only labor and burden and raw materials fabricated by plaintiff appeared in that account on plaintiff's books. Purchased components and material were put directly in finished goods as items were completed. Plaintiff also furnished material to small subcontractors in the vicinity of its plants and paid them on an hourly rate for work thereon, all directions and specifications being supplied by plaintiff. Although strictly work in process, such material was not reflected in that account on plaintiff's books.

9. As of any given date, no accurate determination of work in process could have been made from plaintiff's books and records. Only a physical count would have disclosed the actual work in process on any particular date. No effort was ever made by plaintiff to ascertain the full extent of the amount of its work in process on the pertinent contracts.

10. Subcontracting was arranged by plaintiff's Procurement and Engineering Division. Between 1,500 and 2,000 subcontractors and suppliers located throughout the United States were involved.

11. All plaintiff's war contracts were with the Bureau of Ships, were reduced to writing, and were approved on behalf of the defendant in Washington, D.C. Commander Hezlep was the Supervisor of Shipbuilding located with plaintiff's Procurement and Engineering Division in Los Angeles. He administered the contracts for the Navy Department, adjudicated change orders, and represented the Navy with respect to modifications.

12. Early in 1945 plaintiff became aware of the possibility of termination of its contracts and desired to de-

velop an expeditious method of arriving at the costs resulting from cancellation.

13. Pretermination conferences were held at the Bureau of Ships in Washington on June 20 and 21 and during the week of July 2, 1945. Plaintiff was represented by Messrs. Davies, Carter, Pope, Hait and Cook; the Bureau of Ships by Captain Rosenstein, Lieutenant Commander Pettingill and Lieutenants Bassett, Leva and Yeager. Mr. Davies was plaintiff's president, and Captain Rosenstein was the contracting officer of the Bureau of Ships charged with the responsibility for handling plaintiff's contracts.

14. Subjects discussed at the pretermination conferences were the manner of counting and classification, preservation and disposal of inventories, the rate of profit plaintiff would receive, and the approximate amounts involved. With respect to the rate of profit, plaintiff proposed an overall rate of 6.4 percent, the rate granted by the Army to Studebaker, another contractor engaged in manufacturing a similar vehicle. The Navy countered with the proposal, used by it generally in termination negotiations, of 3 percent on materials and purchased parts, and 10 percent on work in process. Plaintiff estimated that the proportion of inventories, consisting of work in process would be at least 25 percent. This estimate was based upon plaintiff's historical experience. Assuming that 25 percent of plaintiff's inventories consisted of work in process, the application of a 3 percent rate on raw materials and purchased parts, and a 10 percent rate on work in process would have yielded an overall rate of 4.750 percent. Plaintiff contended that its work in process

on the pertinent contracts somewhat exceeded 25 percent. After discussion a profit rate of 4.875 percent emerged, and it was orally agreed by the conferees that plaintiff would submit its termination claims on that basis.

15. After the pretermination conferences, the Bureau of Ships, by letter dated July 19, 1945, submitted to plaintiff a draft of a pretermination agreement labeled "Draft of July 16, 1945", which referred to five of plaintiff's principal war contracts, NObs. 1666, 2017, 2018, 2155 and 1394. Included in this draft as paragraph 4(d) was the following:

> *Profit:* Profit will be paid by the Government to the contractor at the rate of 4.875% of the Contractor's own costs with respect to the terminated portion of the contract. The base on which this rate of profit is computed shall include any expenses in connection with the packing of component parts for which the Contractor has not been compensated under Article 2(b) and 2(c) hereof, but shall not include the items specified in subparagraph (e) hereof, nor shall it include the amount of any subcontractors' termination charges.

The draft contained extensive provisions concerning taking of inventories of fabricated or unfabricated parts, work in process, complete articles, components, supplies and other materials, as well as proposed agreements concerning classification of items of and disposal of termination inventory, an article unilaterally proposed by plaintiff (not acted upon by the contracting officer) concerning the pricing and disposition of scrap materials, and various proposed agreements concerning the computation of the plaintiff's claims.

The defendant's letter of transmittal of the draft of the proposed pretermination agreement stated that the submitted draft was the outgrowth of an earlier draft proposed by the plaintiff, and that the defendant's draft did not purport to be in final form and was not binding on either the Government or the plaintiff.

16. Plaintiff made no formal reply to the Navy letter of July 19, 1945. While the draft of the proposed pretermination agreement was being circulated among plaintiff's personnel for comments and suggestions, the war came to an end and the contracts in question were terminated. The proposed pretermination agreement was never executed.

17. On August 18, 1945, plaintiff's Controller circulated an inter-office directive that termination was to proceed under the Joint Termination Regulation and not under the proposed pretermination agreement. He advised that the proposed agreement was never executed and was of no significance. Plaintiff's post-termination activities with respect to its terminated war contracts did proceed under the Joint Termination Regulation.

18. When the termination notices issued by the Navy Department were received by plaintiff, work was stopped, suppliers and subcontractors were notified to stop work, and preparations were begun for inventory counts. The termination notices, however, did not stop all production since vehicles which had progressed through the paint shop were to be completed. The work in process inventories which were then on the feed lines of subcontractors and subassembly lines of plaintiff's largest assembly plants were immediately reviewed with representatives of the Navy Department, and the disposition of such matter

in some cases was ascertained right at that point. The subassemblies which were not used as such in the spare parts supplied under plaintiff's contracts were disassembled, and the component parts returned to the stock bin of similar parts. The semi-fabricated pieces were scrapped. Materials in process were returned to stock bins.

19. After various materials and parts had been returned to the stock bins, the customary preparation for inventory counting was undertaken, files straightened, and the materials properly identified for the count. The return of materials and parts to the stock bins had been made with the knowledge and approval of the Navy Department. Under the circumstances existing at the time plaintiff's inventory was taken, it was not possible to segregate between purchased parts and raw materials and work in process with respect to the terminated contracts.

20. The portions of the terminated war contracts which had been performed and billed to the Navy Department prior to August 17, 1945, and the balances remaining unperformed on September 30, 1945, were as follows:

Contract NObs.	Face amount of contract	Amount delivered at termination date	Undelivered on Sept. 30, 1945
1394 (Supplement)	$126,448,846.14	$85,781,300.89	$40,667,545.25
1666	27,854,250.00	20,616,750.00	7,237,500.00
2011	1,867,461.00	407,818.00	1,459,643.00
2017	6,570,250.00		6,570,250.00
2018	39,711,000.00	13,146,000.00	26,565,000.00
2155	3,822,000.00		3,822,000.00
2166	3,700,000.00		3,700,000.00
22163	80,000.00	32,362.03	47,637.97
22512	207,750.00	6,925.00	200,825.00
23180	3,110,035.00		3,110,035.00
31131	8,107.00		8,107.00

21. On August 29, 1945, plaintiff requested permission to file one joint inventory schedule and settlement proposal covering contracts NObs. 1666, 2017, 1394 (Supplemental), and 2011, and one joint inventory schedule and settlement proposal covering contracts NObs. 2018, 2166 and 2155. At this same time plaintiff requested that it be relieved of the obligation of allocating between prime contracts the claims of its subcontractors. The basis of plaintiff's request was that "the contractor's inventory and accounting figures do not reflect either items or costs separately for these NObs. contracts, and any accurate allocation among such contracts could not be accomplished without unreasonable delay or effort."

22. By letter dated September 21, 1945, Captain Rosenstein approved plaintiff's request to file two settlement claims and two inventory schedules and to allocate its consolidated inventories to the individual contracts on a percentage basis. In the same letter Captain Rosenstein confirmed the understanding reached with plaintiff's president, Mr. Davies, on September 18, 1945, this meeting being the reference (c) mentioned in the quoted part of the letter below, that the profit rate of 4.875 percent which had been agreed upon for purposes of reaching a pre-termination agreement remained mutually agreeable, and would be claimed by plaintiff and be allowed by him when the termination claims were filed. The language appearing in such letter with regard to the profit rate is as follows:

> It will be recalled that during negotiations with the Contractor looking toward a pre-termination agreement, a profit figure was agreed upon between the Contractor and the Contracting Officer of 4.875%, which figure would have been incorporated in the

agreement had it been consummated. During the course of reference (c), the Contracting Officer on behalf of the Bureau of Ships, and Mr. Davies on behalf of the Contractor, agreed that this profit figure of 4.875%, which had previously been agreed upon for purposes of the pre-termination agreement, was mutually agreeable and would be claimed and allowed in the termination claims submitted by the Contractor under the subject contracts.

23. It was understood by and between the conferees for the parties at the pretermination conference, and by and between Mr. Davies and Captain Rosenstein at the meeting on September 18, 1945, that the 4.875 percent rate of profit would be subject to review by the defendant's Settlement Review Board in Washington. Negotiation was the only method of settlement used in settling plaintiff's termination claims, and all parties understood that written agreements would have to be reached.

24. On November 2, 1945, plaintiff requested permission to allocate subcontract charges among the various contracts on the basis of the relative canceled face value of each contract.

25. With respect to contracts NObs. 1394 (Supplemental) and NObs. 2017, two terminations were involved, one dated July 20, 1945, for both contracts; one dated August 13, 1945 for NObs. 1394 (Supplemental); and one dated August 30, 1945, for NObs. 2017. On November 12, 1945, plaintiff requested permission to consolidate its claims on both terminations and to set August 17, 1945, as the consolidated termination date. The Navy had contended that the consolidated termination date should be

August 30, 1945, and plaintiff was requested to submit reasons justifying the earlier date.

26. Difficulties arose in processing and apportioning plaintiff's inventories on the basis of two joint claims covering certain contracts and individual claims covering other contracts. On November 15, 1945, plaintiff requested permission to file one settlement proposal based upon combined inventories for all its terminated war contracts and to apportion charges among all the contracts according to the percentage ratio of the terminated portions of each contract.

27. On or about November 26, 1945, plaintiff received verbal authorization from Captain Rosenstein to submit a single consolidated claim covering all its terminated war contracts, to treat August 17, 1945, as the consolidated termination date, and to allocate charges among the terminated contracts on the basis of the relative canceled face value of each. This verbal authorization was confirmed by the Supervisor of Shipbuilding in a letter dated December 7, 1945.

28. After it had been advised by Captain Rosenstein that submission of one overall claim and use of August 17, 1945, as the consolidated date of termination would be acceptable to him, plaintiff filed with the Navy Department its first settlement proposal on November 27, 1945.

29. The termination claim as filed by plaintiff on November 27, 1945, set forth a total inventory of metals, purchased parts, finished components and work in process of $18,618,592.43. To this figure plaintiff applied the 4.875 percent profit rate to arrive at its claimed profit of $907,656.38.

30. When the physical count of plaintiff's inventories was taken it was not made under conditions as they existed at the effective date of termination as detailed in findings 18 and 19. Many assemblies were disassembled at the request of the Navy for use as spares. The amount of material so classified as material and purchased parts rather than work in process is impossible of estimation. Boxing of spare parts, which had been or were in process of being boxed for export, was completed before the inventory count was taken. These were classified as material rather than work in process.

31. After plaintiff had presented its first settlement proposal, questions arose concerning the treatment of various items included therein. These matters were taken up with Commander Hezlep, the Supervisor of Shipbuilding, in Los Angeles. Differences which could not be resolved with Commander Hezlep were taken up with Captain Rosenstein in Washington and resolved with him. It was understood that such resolution was subject to review by the Settlement Review Board in Washington and that the settlement terms were to be embodied in a written agreement signed by the parties.

32. Plaintiff's claim was received by the Contract Termination Section of the Navy Department, Bureau of Ships, Washington, D.C., on or about January 3, 1946. Accompanying such claim was a report dated December 14, 1945, by the Supervisor of Shipbuilding charged with the responsibility for plaintiff's contracts. This report stated that the inventory schedules of the contractor had been examined by such office or other authorized Navy Department personnel; that based upon such examination

the Supervisor of Shipbuilding was of the opinion that the inventories were in good physical condition and included no rejects or spoilage; that the inventories had been spotchecked for allocability; that based on such examination, all of the inventories were allocable to the canceled portions of plaintiff's terminated contracts; and that prices had been checked and that the amounts of raw material and purchased parts listed on such inventories were considered reasonable. The report also noted the fact that the profit requested was based on the amount agreed to by Captain Rosenstein and Mr. Davies at the meeting of September 18, 1945, and that the purchased parts shown in the claim as filed formed a larger percentage of the total inventories than would have been anticipated at the time of the profit negotiations. The report further called attention to questionable items contained in plaintiff's claim, such as the failure to deduct from cost the amount of cash discounts, for which no adjustment had been required because of plaintiff's waiver of other items of cost which might properly have been claimed.

33. Plaintiff had not deducted cash discounts from the inventory prices listed in its claim. Instead of minutely examining each item and requiring the deduction of the discount taken with respect to it, the Supervisor estimated the total amount at no more than $360,000 and no adjustment was required because of plaintiff's agreement to waive the items of cost listed in finding 40, which items plaintiff might legitimately have claimed. An inspection of plaintiff's inventories by the Supervisory Cost Inspector disclosed net overstatements of approximately

$7,000. No adjustment was required because of plaintiff's waiver of the same potentially allowable items of cost.

34. On January 8, 1946, Captain Rosenstein, the assigned contracting officer, Commander Gordon Rule, the head of the Bureau's Vessel Termination Section, and Lieutenant Bassett met with representatives of the plaintiff, Paul A. Davies, President, and B. C. Carter, Controller, and discussed plaintiff's settlement proposal.

35. At this meeting the reasonableness of the 4.875 percent rate of profit claimed by plaintiff was questioned because it had been predicated on an estimate that at least 25 percent of plaintiff's inventories consisted of work in process, whereas plaintiff's settlement proposal showed work in process of only approximately 7 percent. Captain Rosenstein requested plaintiff to supply him information to justify the reasonableness of an allowance of profit at the 4.875 percent rate. Plaintiff complied by letter dated February 13, 1946.

36. Plaintiff was also requested to file an application for a partial payment. Because of the difference in interest plaintiff expected to receive on its termination claims, as opposed to the interest it was required to pay on loans obtained with Government guarantee (VT Loans), plaintiff refused the Navy's request that it apply for partial payment.

37. Captain Rosenstein and the other Navy personnel concerned with plaintiff's termination claims at that time determined that they would recommend to the Settlement Review Board that a partial payment in the amount of $18,500,000 be made to plaintiff. Accordingly, they pre-

pared a memorandum to be submitted to the Settlement Review Board and the Chief of the Bureau of Ships for approval of such partial settlement. In such memorandum it was stated:

> The claim has been negotiated with the Contractor and it is the opinion of the Contracting Officer that not less than the total amount of this claim is owing and will be paid to the Contractor.

This recommendation was approved by the Settlement Review Board and the Chief of the Bureau of Ships and a check for $18,500,000 was tendered to and accepted by the plaintiff's president, Mr. Davies, when he returned to Captain Rosenstein's office on January 10, 1946. The $18,500,000 allowed at that time represented approximately 95 percent of plaintiff's total claim of $19,526,248.81. It was $118,592.43 less than the amount claimed in respect of inventories and did not represent any allowance for profit or disposal credits.

38. By letter dated February 13, 1946, plaintiff justified the profit rate by advising that it had listed in its settlement proposal as work in process only items which were unquestionably that. Also, because of the impossibility of segregating and identifying work in process, and because such identification had no consequence in view of plaintiff's claim for an overall rate of profit, much work was not classified as work in process although it was legitimately that. Reduction in 1945 of lead time from about 200 vehicles to 60 vehicles is estimated to have reduced expected work in process by approximately $1,325,000.

39. Plaintiff further justified the reasonableness of the negotiated rate of 4.875 percent, not by attempting to apply the separate rates of paragraph (d) of the Uniform Termination Article to separate classes of plaintiff's inventories, but rather by the waiver of unrelated legitimate costs and the showing of additional items which were legitimately work in process but which were not so classified.

40. Plaintiff agreed to waive the following items of cost:

(a) $280,000 freight on termination inventories.

(b) $400,000 cost of boxing Riverside inventories for shipment as spare parts.

(c) $144,000 burden on work in process.

(d) $350,000 general and administrative expenses incurred prior to termination.

(e) $200,000 settlement expenses incurred prior to October 1, 1945.

(f) $4,000,000 billings on approved change orders.

41. After receipt of plaintiff's letter concerning reasons why the 4.875 percent rate should be allowed, Captain Rosenstein on March 26, 1946, submitted his written proposals for settlement of plaintiff's claim to the Settlement Review Board. With one exception, he recommended approval of plaintiff's claim as it was submitted on November 27, 1945, including allowance of profit at the rate of 4.875 percent. The exception concerned freight charges in the sum of $21,222. A dispute had arisen concerning certain freight charges claimed by plaintiff as a part of

its inventory costs, and plaintiff, after negotiation, agreed to decrease its claim for metals inventory by the amount of $21,222, and the Settlement Review Board was so advised.

42. On March 27, 1946, after considering the evidence before it and discussion of the various items of the claim, the Settlement Review Board certified its approval of the proposed settlement agreement as it was contained in plaintiff's claim and the report and recommendation of the contracting officer. This constituted a partial settlement of the matters involved in the termination of the contracts, and was recognized by the Board as such. The action of the Board was approved by the Chief of the Bureau of Ships.

43. By letter dated April 11, 1946, the Navy submitted to plaintiff for execution two supplemental agreements covering the plaintiff's termination claim as approved by the Settlement Review Board and the Chief of the Bureau of Ships.

44. At no time were negotiations conducted on the basis of plaintiff's being entitled to a minimum amount of profit computed under the formula set forth in paragraph (d) of the Uniform Termination Article contained in some of the terminated contracts.

45. On May 21, 1946, plaintiff returned to the defendant executed copies of the supplemental contract supplied by the Navy Department, as stated in finding 41. On or about June 6, 1946, plaintiff received one copy of each of these supplemental contracts which had been executed on behalf of the Navy Department. Payments of the

amounts set forth in the supplemental contracts (the amounts due after deduction of the partial payment of $18,500,000) were received by plaintiff as follows: June 12, 1946, $817,670.52, and June 13, 1946, $62,747.95, representing the principal sum payable, $876,669.97, together with interest from the date of said agreements, March 27, 1946, to the date of payment, in the amount of $3,748.50.

46. Between November 27, 1945, and October 22, 1946, plaintiff submitted 11 additional settlement proposals to the Navy Department.

47. On September 9, 1946, plaintiff submitted its 10th interim settlement proposal and claimed therein for the first time its settlement expenses incurred after October 1, 1945, in the aggregate amount of $590,077.65 accrued on plaintiff's books as having been incurred in the following tax periods:

Description	Tax period Oct. 1, 1945, to Dec. 31, 1945	Calendar year 1946	Total
Procurement and Engineering Division	$ 99,420.39	$171,143.47	$270,563.86
Other Divisions	101,096.29	90,917.50	192,013.79
Home Office-Administrative	45,000.00	82,500.00	127,500.00
	$245,516.68	$344,560.97	$590,077.65

48. Under a general authorization made applicable to plaintiff on May 21, 1945, plaintiff was authorized to make final settlements of its subcontractors' termination claims amounting to less than $10,000. On December 19, 1945, the Navy Department authorized disbursal to plaintiff of a fund of $15,000,000 as an advance for the purpose of

permitting plaintiff to make payments to its subcontractors on account of their claims against plaintiff arising out of the termination by plaintiff of subcontracts pertaining to the contracts listed in finding 3. On January 3, 1946, plaintiff received the $15,000,000 restricted fund for use in settling claims under the provisions of the Contract Settlement Act of 1944. All of the settlements with subcontractors made by plaintiff on the claims were covered by Settlement Proposal No. 12. Plaintiff was not allowed interest on disbursements from this fund, but was allowed interest on its own corporate funds used in settlements of subcontractors' claims.

49. Plaintiff's 12th and final settlement proposal was submitted to the Navy Department on October 22, 1946, and the final disposition of plaintiff's claims in connection with the termination of its war contracts, including its settlements with subcontractors, was made on the basis thereof. The profit allowance of $906,621.81, previously allowed in the first claim and included in the proposal for final disposition, was 4.875 percent of $18,597,370.43, which sum was the total amount of plaintiff's previously allowed inventory of metals, purchased parts, finished components, and work in process.

This final settlement proposal provided for an allowance for settlement expenses (including general and administrative among others) of $590,077.65 and an allowance for interest of $160,745.10. The amount of $590,077.65 represented total expenses of $610,130.53 allocable to plaintiff's terminated war contracts for the period October 1, 1945, to September 30, 1946, inclusive, less expenses in the amount of $20,052.88 absorbed by plaintiff.

The amount of $160,745.10 represented interest at the rate of 2½ percent on the principal amount of $19,220,150.37 for the period commencing 30 days after the effective date of termination of plaintiff's aforesaid war contracts to January 10, 1946, inclusive, plus interest at the rate of 2½ percent on $720,150.37 for the period January 11, 1946, to June 11, 1946, inclusive, plus the amount of $477 representing interest charged against the Navy Department by plaintiff on account of the use of plaintiff's funds in settlement of subcontractors' claims in connection with its terminated war contracts. The principal amount of $19,220,150.37 was computed per plaintiff's 12th settlement proposal as follows:

Metals	$1,321,027.72
Purchased Parts	15,410,599.86
Finished Components	711,094.32
Work in Process	1,154,648.53
	18,597,370.43
Add: Profit Allowance	906,621.81
Total	19,503,992.24
Deduct: Disposal credits	283,841.87
Balance	19,220,150.37

The amount of $720,150.37 was computed as follows:

Amount due plaintiff per 12th settlement proposal	$19,220,150.37
Payment on account Jan. 10, 1946	18,500,000.00
Balance	720,150.37

50. Rear Admiral F. J. Wille, Contracting Officer of the Bureau of Ships, recommended approval by the Settlement Review Board of plaintiff's 12th and final settlement proposal in a memorandum dated November 19, 1946.

The Settlement Review Board approved the final settlement of plaintiff's claim on November 26, 1946. Final settlement was also approved by the Chief of the Bureau of Ships.

51. On December 12, 1946, the Navy Department transmitted to plaintiff two proposed settlement agreements, in the form of second supplemental contracts, proposing a final settlement of plaintiff's claims arising out of the termination of the war contracts listed in finding 3. On December 19, 1946, plaintiff returned executed copies of the second supplemental contracts to the Navy Department. On January 3, 1947, plaintiff received one copy of each of the second supplemental contracts which had been executed on behalf of the Navy Department. Plaintiff received its final payment for additional interest allowed by the Navy Department on January 3, 1947. On January 9, 1947, plaintiff received the U.S. Treasury Department's check dated January 3, 1947, in settlement of the balance due on its termination claims, in the amount of $604,674.57, computed as follows:

Settlement expenses	$462,577.65
General and administrative expenses	127,500.00
	590,077.65
Interest	14,477.00
Total	604,554.65
Interest	119.92
Total	604,674.57

52. Prior to the payments to the plaintiff set forth in finding 51, plaintiff received payments on account of the termination of its war contracts listed in finding 3, in the amounts and on the items as follows:

Termination inventories	$18,597,370.43
Profit allowance	906,621.81
Total interest allowance	160,745.10
Aggregate amount due	19,664,737.34
Payments received by plaintiff:	
Jan. 10, 1946	$18,500,000.00
June 12, 1946	817,670.52
June 13, 1946	62,747.95
Additional interest received by plaintiff on Jan. 3, 1947	477.00
Disposal credits	283,841.87
Total	19,664,737.34

53. During negotiations, an attorney for the Navy suggested that, for Federal income and excess profits tax purposes, the profit allowance with respect to plaintiff's terminated war contracts might be accruable in 1946 rather than in the tax year ended September 30, 1945. However, because of the position taken by the Commissioner of Internal Revenue in Mimeograph No. 5897, C.B. 1945, 131, plaintiff decided to include the profit allowance in its 1945 income and file a claim for refund.

54. In its corporate income and declared value excess profits tax return for the tax year ended September 30, 1945, plaintiff reported ordinary net income, prior to adjustment on account of excess profits net income and dividends received credit, in the amount of $20,662,580.87, and in its excess profits tax return for the pertinent tax year plaintiff reported excess profits net income in the amount of $20,548,532.04, and adjusted excess profits net income in the amount of $18,897,662.07, after application of the specific exemption of $10,000 and the excess profits credit (based on income) of $1,640,869.97.

55. Included in the computation of plaintiff's normal tax net income, surtax net income and excess profits net

income reported for the tax year ended September 30, 1945, was the amount of $907,656.38, which amount plaintiff included in its gross income for the pertinent tax year on account of its claims against the defendant by reason of the latter's termination of plaintiff's contracts referred to in finding 3.

56. In its excess profits tax return for the tax year ended September 30, 1945, plaintiff computed and disclosed its excess profits tax liability for such tax year in the amount of $14,194,588.68, and its income tax liability for such year in the total amount of $667,783.17. Plaintiff paid to the Collector the amount of its income tax and excess profits tax liabilities as disclosed by its returns as follows:

Date of payment	Income tax paid	Excess profits tax paid	Total payment
Dec. 13, 1945	$225,000.00	$3,809,290.69	$4,034,290.00
Mar. 13, 1946	442,783.17	3,297,216.83	3,740,000.00
June 13, 1946		3,372,488.00	3,372,488.00
Sept. 11, 1946		3,715,593.85	3,715,593.85
Total	667,783.17	14,194,588.68	14,862,371.85

Plaintiff did not incur any liability on account of declared value excess profits tax for the tax year ended September 30, 1945.

57. On December 29, 1945, the Commissioner of Internal Revenue granted plaintiff permission to change its accounting year for tax purposes from a tax year ending September 30 to a calendar year ending December 31. Plaintiff filed with the Collector its corporate income and excess profits tax returns for the short tax period October 1, 1945, to December 31, 1945, and has subsequently prepared and filed its corporate tax returns on the calendar year basis.

58. The Commissioner of Internal Revenue, upon audit and review of plaintiff's income and excess profits tax returns for the tax year ended September 30, 1945, determined an overassessment in plaintiff's income tax liability for that tax year in the amount of $347.15 and determined a deficiency in plaintiff's excess profits tax liability for that year in the amount of $267,107.79. The asserted deficiency in plaintiff's excess profits tax for that year was assessed and was satisfied by plaintiff, together with interest thereon, as follows:

Date of payment	Amount	Interest
Aug. 21, 1947	$124,542.08	$12,577.04
June 11, 1948 (amounts offset by credit for overassessment on account of plaintiff's 1944 excess profits tax liability)	142,565.71	21,304.78
	267,107.79	33,881.82

59. The amount of $124,542.08 (additional excess profits tax), paid by plaintiff to the Collector on August 21, 1947, together with interest thereon in the amount of $12,577.04, was occasioned by certain uncontested adjustments made by the Commissioner of Internal Revenue to plaintiff's taxable income for the tax year ended September 30, 1945. On June 11, 1948, the balance of the asserted deficiency for the tax year ended September 30, 1945, was satisfied by credit in the amount of $142,565.71, together with interest thereon of $21,304.78, from an overassessment of plaintiff's excess profits tax liability for the tax year ended September 30, 1944, determined and allowed by the Commissioner of Internal Revenue in the total amount of $556,309.72, exclusive of interest thereon.

60. In making the above-mentioned adjustments to plaintiff's corporate income tax and excess profits tax lia-

bilities for the tax year ended September 30, 1945, the Commissioner of Internal Revenue determined that the adjusted net income of plaintiff was in the amount of $22,014,426.27; that its normal tax and surtax net income was in the amount of $1,672,941.41, resulting in a determined corporate income tax liability of $667,436.02; and that plaintiff's adjusted excess profits net income for that tax year was $20,250,669.65, resulting in a determined excess profits tax liability of $15,161,004.34.

61. On May 1, 1947, plaintiff paid to the Collector on account of its excess profits tax liability for the tax year ended September 30, 1945, the amount of $699,307.87, together with interest for the period to May 2, 1947, in the amount of $57,898.86. Having reported and paid original excess profits tax liability for the tax year ended September 30, 1945, of $14,194,588.68, plaintiff thus had had assessed against it and had paid, total excess profits tax for the pertinent tax year of $14,893,896.55, plus the excess profits tax assessment of $267,107.79 assessed and satisfied as shown in finding 58, or a total excess profits tax liability determined for the tax year ended September 30, 1945, of $15,161,004.34.

62. Plaintiff's overassessment of income tax for the tax year ended September 30, 1945, was credited to plaintiff's account, and the deficiencies in excess profits tax liability as determined for the same year were paid or satisfied as shown hereinabove. In his determination of plaintiff's income tax and excess profits tax liabilities for the tax year ended September 30, 1945, the Commissioner of Internal Revenue included in plaintiff's income the amount of $906,621.81 on account of its claims arising out of the termination of its war contracts listed in finding 3, rather

than the $907,656.38 reported by plaintiff in filing its return for such year. This reduction in income was made to reflect the elimination of the $21,222 of freight charges from plaintiff's termination inventory, as related in finding 39, the application of the profit rate of 4.875 percent being made to the total sum of the inventory as reduced to that extent.

63. On November 9, 1950, plaintiff filed with the Collector a claim for refund of income and excess profits taxes exacted for the tax year ended September 30, 1945, in the amount of $652,767.67, plus statutory interest thereon.

64. In accordance with the provisions of Section 3772 of the Internal Revenue Code of 1939, the Commissioner of Internal Revenue notified plaintiff of the disallowance of its claim for refund for the tax year ended September 30, 1945, on April 24, 1952. The basis of the Commissioner's rejection was his determination that the amount of $906,621.81 was includible in plaintiff's income for the tax year ended September 30, 1945. No part of any sum representing the instant claim which was collected from plaintiff as aforesaid by the Collector has been refunded, repaid or credited to plaintiff.

65. Plaintiff's petition was timely filed in this Court on April 8, 1954. The grounds upon which this case was presented and tried are the same as those stated in the claim for refund.

Conclusion of Law

Upon the foregoing findings of fact, which are made a part of the judgment herein, the court concludes as a matter of law that plaintiff is not entitled to recover and its petition is dismissed.

Appendix B

Internal Revenue Code of 1939:

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; • • •.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [As amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. • • •

(26 U.S.C. 1952 ed., Sec. 42.)

Contract Settlement Act of 1944, c. 358, 58 Stat. 649:

SEC. 6. (a) It is the policy of the Government, and it shall be the responsibility of the contracting agencies and the Director, to provide war contractors with speedy and fair compensation for the termination of any war contract, in accordance with and subject to the provisions of this Act, giving priority to contractors whose facilities are privately owned or privately operated. Such fair compensation for the termination of subcontracts shall be based on the same principles as compensation for the termination of prime contracts.

(b) Each contracting agency shall establish methods and standards, suitable to the conditions of various war contractors, for determining fair compensation for the termination of war contracts on the basis of actual, standard, average, or estimated costs, or of a percentage of the contract price based on the estimated percentage of completion of work under the terminated contract, or on any other equitable basis, as it deems appropriate. To the extent that such methods and standards require accounting, they shall be adapted, so far as practicable, to the accounting systems used by war contractors, if consistent with recognized commercial accounting practice.

(c) Any contracting agency may settle all or any part of any termination claim under any war contract by agreement with the war contractor, or by determination of the amount due on the claim or part thereof without such agreement, or by any combination of these methods. Where any such settlement is made by agreement, the settlement shall be final and conclusive, except (1) to the extent otherwise agreed in the settlement; (2) for fraud; (3) upon renegotiation to eliminate excessive profits under the Renegotiation Act, unless exempt or exempted under that Act; or (4) by mutual agreement before or after payment. Where any such settlement is made by determination without agreement, it shall likewise be final and conclusive, subject to the same exceptions as if made by agreement, unless the war contractor appeals or brings suit in accordance with section 13 of this Act: *Provided*, That no settlement agreement hereunder involving payment to a war contractor of an amount in excess of $50,000 (or such lesser amount as the Director may from time to time determine) shall become binding upon the Govern-

ment until the agreement has been reviewed and approved by a settlement review board of three or more members established by the contracting agency in the bureau, division, regional or district office, or other unit of the contracting agency authorized to make such settlement, or in the event of disapproval by the settlement review board, unless approved by the head of such bureau, division, regional or district office, or other unit. Failure of the settlement review board to act upon any settlement within thirty days after its submission to the board shall operate as approval by the board. The sole function of settlement review boards shall be to determine the over-all reasonableness of proposed settlement agreements from the point of view of protecting the interests of the Government. In determining, for purposes of this subsection, whether review of any settlement agreement is required because of the amounts involved, no deduction shall be made on account of credits for property chargeable to the Government or for advance or partial payments, but amounts payable under such settlement agreement for completed articles or work at the contract price and for the discharge of the termination claims of subcontractors shall be deducted.

(d) Except as hereinafter provided, the methods and standards established under subsection (b) of this section for determining fair compensation for termination claims which are not settled by agreement shall be designed to compensate the war contractor fairly for the termination of the war contract, taking into account—

(1) the direct and indirect manufacturing, selling and distribution, administrative and other costs and expenses

incurred by the war contractor which are reasonably necessary for the performance of the war contract and properly allocable to the terminated portion thereof under recognized commercial accounting practices; and

(2) reasonable costs and expenses of settling termination claims of subcontractors related to the terminated portion of the war contract; and

(3) reasonable accounting, legal, clerical, and other costs and expenses incident to termination and settlement of the terminated war contract; and

(4) reasonable costs and expenses of removing, preserving, storing and disposing of termination inventories; and

(5) such allowance for profit on the preparations made and work done for the terminated portion of the war contract as is reasonable under the circumstances; and

(6) interest on the termination claim in accordance with subsection (f) of this section; and

(7) the contract price and all amounts otherwise paid or payable under the contract.

The following shall not be included as elements of cost:

(i) Losses on other contracts or from sales or exchanges of capital assets, fees and other expenses in connection with reorganization or recapitalization, antitrust or Federal income-tax litigation, or prosecution of Federal income-tax claims or other claims against the Government (except as provided in paragraph (3) above); losses on investments; provisions for contingencies; and premiums on life insurance where the contractor is the beneficiary.

(ii) The expense of conversion of the contractor's facilities to uses other than the performance of the contract.

(iii) Expenses due to the negligence or willful failure of the contractor to discontinue with reasonable promptness the incurring of expenses after the effective date of the termination notice.

(iv) Costs incurred in respect to facilities, materials, or services purchased or work done in excess of the reasonable quantitative requirements of the entire contract.

The failure specifically to mention in this subsection any item of cost is not intended to imply that it should be allowed or disallowed. The Director may interpret the provisions of this subsection (d) and may provide for the inclusion or exclusion of other costs in accordance with recognized commercial accounting practice.

Where the small size of claims or the nature of production or performance or other factors make it impracticable to apply the principles stated in this subsection (d) to any class of settlements which are subject to this subsection (d), the contracting agencies may establish alternative methods and standards for determining fair compensation for that class of termination claims. The aggregate amount of compensation allowed in accordance with this subsection (excluding amounts allowed under paragraphs (3) and (4) above) shall not exceed the total contract price reduced by the amount of payments otherwise made or to be made under the contract.

(e) In order to carry out the objectives of this Act, termination claims shall be settled by agreement to the maximum extent feasible and the methods and standards established under subsection (b) of this section shall be designed to facilitate such settlements. To the extent that he deems it practicable to do so without impeding ex-

peditious settlements, the Director shall require the contracting agencies to take into account the factors enumerated in subsection (d) above in establishing methods and standards for determining fair compensation in the settlement of termination claims by agreement.

• • • • •

(g) Where any war contract does not provide for or provides against such fair compensation for its termination, the contracting agency, either before or after its termination, shall amend such war contract by agreement with the war contractor, or shall authorize, approve, or ratify an amendment of such war contract by the parties thereto, to provide for such fair compensation.

(41 U.S.C. 1952 ed., Sec. 106.)

Treasury Regulations 111:

SEC. 29.42-1. (Italics indicate changes made by T.D. 5405, C.B. 1944, 154, Sep. 22, 1944) (a) In general.—Except as otherwise provided in Section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. (See Sections 29.41-1 to 29.41-3, inclusive.) • • • *Except as otherwise stated in this subsection*, such items as claims for compensation under canceled Government contracts constitute income for the year in which they are allowed or their value is otherwise definitely determined, if the return is rendered on the accrual basis; or for the year in which received, if the return is rendered on the basis of cash receipts and disbursements. *In the case of a termination of a war contract as defined by Section 3*

of the Contract Settlement Act of 1944 (or the termination of any other Government contract as to which the right to compensation is definitely fixed and the measure thereof is determinable with reasonable accuracy), if the return is rendered on a basis other than cash receipts and disbursements, compensation for the termination shall, unless a different method of reporting is prescribed or approved by the Commissioner, constitute income for the taxable year in which falls the effective date of the termination, except that if any part of the compensation is attributable to cost, expenses, or losses incurred in a subsequent year such part of the compensation shall be returned as income for the subsequent year.

Mimeograph 5897, C.B. 1945, 131:

Mimeograph 5766 [C.B. 1944, 156], dated November 1, 1944, contains rules governing the treatment of compensation for the termination of fixed-price contracts which constitute war contracts within the meaning of Section 3 of the Contract Settlement Act of 1944 [58 Stat., 649, 650], in cases where the contractor renders his returns other than on a basis of cash receipts and disbursements and the compensation is received pursuant to a negotiated settlement, together with rules with respect to the effect of a no-cost settlement in respect of a termination of a fixed-price contract. The method of treatment therein prescribed will continue to be followed. Pursuant to the provisions of Section 29.42-1 of Regulations 111, as amended by Treasury Decision 5405 [C. B. 1944, 154], approved September 22, 1944, the provisions of Mimeograph 5766 are, however, restated in this mimeograph and are supplemented to prescribe rules for the treatment of compensa-

tion for the termination of all war contracts in all cases where the contractor renders his returns other than on a basis of cash receipts and disbursements.

(a) WHEN COMPENSATION INCLUDED IN GROSS INCOME.—In the case of a termination of a contract which constitutes a war contract within the meaning of Section 3 of the Contract Settlement Act of 1944, compensation for the termination shall be included in computing gross income for the taxable year or years determined in accordance with the following rules:

• • • • •

(2) TAXABLE YEARS ENDING ON OR AFTER JULY 21, 1944.—In case a war contract is terminated within a taxable year ending on or after July 21, 1944, the income from the contract termination shall be included in computing gross income for the taxable year of the contract termination. The foregoing method shall apply in all such cases unless a different method is prescribed or approved by the Commissioner. Notwithstanding the foregoing provisions of this subparagraph, if any part of the compensation is for any particular item of cost, expense, or loss incurred within a taxable year subsequent to the year of the contract termination, such part shall be included in computing gross income for such subsequent year. The rule stated in the preceding sentence is applicable where, for example, any such item is incurred under contractual provisions entitling the contractor to reimbursement, or where the contractor is entitled to compensation for a particular item under contractual provisions relating to the termination, or pursuant to procedures and practices under the Contract Settlement Act of 1944

other than those referred to in the Director's statement in paragraph (b) below.

(3) ADJUSTMENT OF RETURN.—If the income from the contract termination which, under the above subparagraph (1), is to be taken into account in computing gross income for the taxable year in which the Contract Settlement Act of 1944 became effective, or which, under the above subparagraph (2), is to be taken into account for the year of the contract termination, is not definitely ascertained at the time of filing the return, the contractor shall include in his return a reasonable estimate of such income, and should attach to his return a statement identifying the contract termination to which such estimate relates. When the correct amount of such income from the contract termination is ascertained, an adjustment shall be made for the year for which such income was included. (Cf. *Continental Tie & Lumber Co. v. United States*, 286 U. S. 290 [Ct. D. 494, C. B. XI-1, 260 (1932)].)

Procurement Regulations and Joint Termination Regulation, 10 Fed. Register (Part II) 10449:

Subchapter C—Termination of Contracts.

SEC. 845.513 *Settlement by agreement.* The negotiated agreement is the most expeditious and most satisfactory method of settling termination claims. This method will be used for settlement whenever feasible. Other methods of settlement will be resorted to only when a termination claim cannot be fairly settled by agreement. [JTR 513]

SEC. 845.531 *General standards for negotiating settlement.*

(a) The primary objective in negotiating a settlement is to agree on an amount to compensate the war contractor

fairly and fully for the work done and the preparations made for the terminated portion of the contract, with such allowances for profit thereon as is reasonable under the circumstances.

(b) Such fair compensation for termination is inherently a matter of judgment and therefore cannot be measured exactly. In a given case, various methods may be equally appropriate for arriving at fair compensation; and differing amounts, resulting from reasonable variations of method and of sound judgment may all be regarded as constituting fair compensation.

(c) Cost and accounting data may provide guides for ascertaining fair compensation but are not rigid measures of it. Other types of data, criteria, or standards may furnish equally reliable guides to fair compensation. Settlement by agreement should be facilitated to the maximum extent feasible. The amount of record keeping, reporting and accounting, in connection with settlement of termination claims, will be reduced to the minimum compatible with the reasonable protection of the public interest. [JTR 531]

SEC. 845.532 *Standards for negotiated settlements based on costs and profits.* [JTR 532]

SEC. 845.532-1 *Application.* In negotiating the amount to be paid the contractor as fair compensation for his claim, it is not necessary to agree on the separate items to be allowed either for costs or profit. The parties may agree upon a total amount without agreeing on the particular elements entering into this amount. However, where the negotiation of the total amount is based on the consideration of costs and profit, the principles stated in

sections 845.532-2 and 845.533 should be observed. [JTR 532.1]

SEC. 845.532-2 *Consideration of costs.* (a) The cost principles set forth in section 845.551 reflect certain policies regarding the types of costs which should ordinarily be taken into account in determining fair compensation for the termination of a war contract. Costs of the types allowed by these principles should be considered in a negotiated settlement based on costs. Conversely, such a settlement should not be made a means for reimbursing expenditures of the types excluded by these principles.

(b) Cost data should be considered as a basis for a business negotiation of a prompt and equitable settlement rather than for an attempt at an exact determination of costs. For the purpose of expediting settlements, costs should be estimated and approximated on reasonable bases, to the fullest extent practicable. Differences should be compromised and questions of doubt settled by agreement.

(c) The scope and function of cost principles and cost data, as outlined above, are not changed by the issuance of Termination Cost Memorandums by the Director of Contract Settlement pursuant to General Regulation No. 14 (see section 845.552-3). These Memorandums are designed to promote greater uniformity in the interpretation of the cost principles, but the principles themselves, insofar as they apply to negotiated settlements, are intended only as a general guide and not in any way as an inflexible rule. [JTR 532.2]

SEC. 845.533 *Allowance for profit on fixed-price contracts.* [JTR 533]

SEC. 845.533-1 *General.* (a) The contractor should be allowed a profit only on preparations made and work done for the terminated portion of the contract (excluding any allowance of profit on post-termination and settlement expenses, such as protection, preservation and disposition of termination inventory, settlement of the prime contract and any subcontracts thereunder, and like costs). Subject to this limitation, any reasonable method may be used to arrive at a fair profit. The most satisfactory criterion of a fair profit is ordinarily what the parties agreed upon, as evidenced by the amount of profit:

(1) Which both parties agreed upon or consented to at the time the contract was negotiated; or

(2) Which the contractor would have earned had the contract been completed; or

(3) Which the contractor agreed to accept in the event the contract was terminated. [JTR 533.1]

SEC. 845.582 *Duty of board to review settlements.* [JTR 582]

SEC. 845.582-1 *Settlements required to be reviewed.* The settlement review board will examine, before its approval or execution by the contracting officer, each proposed settlement made by the Government or made by any war contractor with his subcontractor—

(a) which provides for payment to any prime contractor or to any subcontractor of an amount in excess of $25,000, computed in accordance with section 841.122; or

(b) which adjusts the fixed-fee upon the complete or partial termination of a cost-plus-a-fixed-fee prime con-

tract or subcontract where the estimated cost of the terminated portion exceeds $50,000; or

(c) which does not require review under subparagraph (a) or (b), but which the chief of a service or bureau requires to be submitted for review by the board. [JTR 582.1]

SEC. 845.583 *Scope of review by board.* (a) The sole function of the settlement review board is to determine the over-all reasonableness of the proposed settlement from the standpoint of protecting the Government's interest. The board is not intended to examine in detail every element entering into the determination of the amount to be paid. In order to determine, however, that negotiations have been conducted competently and in the light of adequate information, it will frequently be appropriate for the board to inquire into specific selected items of the proposed settlement.

(b) The board may vary the scope and intensity of the review according to the reliability of the contractor, the size and complexity of the proposed settlement, and any other relevant factors. Whenever review is required for subcontract settlements involving $25,000 or less, the board may, and generally should, limit its review to an inquiry as to whether the prime contractor or any intermediate subcontractor adequately examined the claim and whether it is reasonable to rely on the examination so made.

(c) Where the adjustment of the fixed-fee under a terminated cost-plus-a-fixed-fee war contract made pursuant to a contract formula and not by negotiated agreement is submitted for review, the function of the board in reviewing the adjustment will be to advise the contracting officer with respect to its reasonableness.

(d) The board may act upon records submitted by the contracting officer or may require the submission of additional information. [JTR 583]

SEC. 845.584 *Effect of action by review board.* [JTR 584]

SEC. 845.584-1 *Action by the board.* The review board will submit to the contracting officer a written recommendation with respect to each proposed settlement or other matter considered by the board. The review board must act promptly on all matters submitted for its consideration or approval. Under Section 6(c) of the Act, failure of any review board to act upon any settlement within thirty days after its submission to the board operates as approval by the board. [JTR 584.1]

SEC. 845.584-2 *Necessity for further approval.* (a) If the review board disapproves any proposed settlement, the contracting officer shall not execute it or approve it unless the head of the office in which the board is established approves the settlement.

(b) Where the proposed settlement exceeds $500,000 in amount, or such lesser amount as the chief of the service or bureau may prescribe, the contracting officer shall submit it, after approval by the review board, (1) in the War Department, to such higher authority as the chief of the service may prescribe, or (2) in the Navy Department, to the chief or assistant chief of the bureau, acting personally. The contracting officer shall not execute or approve the settlement until its approval by such authority.

(c) Except as provided in this paragraph, the contracting officer may execute or approve the settlement agreement upon its approval by the review board. [JTR 584.2]

Armed Services Procurement Regulations, 23 Fed. Register 9221:

Part 8, Termination of Contracts:

SEC. 8.203 *Methods of settlement.* Settlement of terminated cost-reimbursement type contracts and of fixed-price type contracts terminated for convenience may be effected by (a) negotiated agreement, (b) determination by the contracting officer, (c) in the case of cost-reimbursement type contracts, costing-out under vouchers using Standard Form 1034, or (d) a combination of these methods. Every effort shall be made to reach a fair and prompt settlement with the contractor. The negotiated agreement is the most expeditious and most satisfactory method of settling termination claims and shall be used whenever feasible. Settlement by determination shall be used only when a termination claim cannot be settled by agreement. [32 CFR 8.203]

SEC. 8.211-2 *Required review and approval.* (a) ***When required.*** Prior to executing a settlement agreement, or issuing a determination of the amount due under the termination clause of a contract, or approving or ratifying a subcontract settlement, the contracting officer shall submit each such settlement or determination for review and approval by a Settlement Review Board if:

(1) The settlement or determination involves $25,000 or more (see § 8.101-1);

(2) The settlement or determination is limited to adjustment of the fee of a cost-reimbursement contract or subcontract and (i) in the case of a complete termination, the fee, as adjusted, is $25,000 or more; or (ii) in the case of a partial termination, the fee, as adjusted, with respect

to the terminated portion of the contract or subcontract is $25,000 or more;

(3) The Head of the Procuring Activity concerned determines that a review is desirable; or

(4) The contracting officer, in his discretion, desires review by the Settlement Review Board.

The review and approval of each settlement or determination in excess of $1,000,000 shall be by a Board at the Head of the Procuring Activity level.

(b) *Submission of information.* The contracting officer shall, in accordance with Departmental procedures, submit to the Settlement Review Board a statement of the settlement, supported by such detailed information as is required for an adequate review. This information should normally include copies of (1) the contractor's or subcontractor's settlement proposal, (2) the audit report, (3) the property disposal report and any required approvals in connection therewith, (4) the contracting officer's memorandum explaining the settlement (§ 8.210), and (5) when appropriate, the opinion of any other Settlement Review Board which has previously reviewed the settlement. The Board may, in its discretion, require the submission of additional information. [32 CFR 8.211-2]

SEC. 8.211-3 *Scope of review.* The function of a Settlement Review Board is to determine the overall reasonableness of the proposed settlement agreement or determination from the standpoint of protecting the Government's interest. The Board may vary the scope and intensity of the review according to the size and com-

plexity of the proposed settlement agreement or determination and any other relevant factors. It is not intended that the Board examine in detail every element entering into the proposed settlement agreement or determination, but the Board may inquire into selected elements of the proposed settlement agreement or determination to assure that it has been conducted competently and is based on adequate information. [32 CFR 8.211-3]

SEC. 8.211-4 *Action by board.* The Settlement Review Board shall submit to the contracting officer a written opinion with respect to the proposed settlement agreement or determination and any other matter considered by the Board setting forth its approval or disapproval thereof, or other decision thereon. Failure of the Board to submit a written opinion as to any proposed settlement agreement or determination within 30 days after submission to the Board of all the information required pursuant to § 8.211-2(b) shall operate as an approval by the Board. [32 CFR 8.211-4]

SEC. 8.300 *Scope of subpart.* This subpart establishes the guilding principles and policies in connection with arriving at fair compensation for the settlement of terminated fixed-price contracts. [32 CFR 8.300]

SEC. 8.301 *General.* (a) A settlement should compensate the contractor fairly for the work done and the preparations made for the terminated portions of the contract, including an allowance for profit thereon which is reasonable under the circumstances. Fair compensation is a matter of judgment and cannot be measured exactly. In a given case, various methods may be equally appro-

priate for arriving at fair compensation. The application of standards of business judgment, as distinguished from strict accounting principles, is the heart of a settlement.

(b) The primary objective is to negotiate a settlement by agreement. The parties may agree upon a total amount to be paid the contractor without agreeing on or segregating the particular elements of costs or profit comprising this amount. But the total amount payable to the contractor, whether through negotiation or by determination, before deducting disposal or other credits and exclusive of settlement costs, shall not exceed the contract price less payments otherwise made or to be made under the contract.

(c) Cost and accounting data may provide guides, but are not rigid measures, for ascertaining fair compensation. In appropriate cases, costs may be estimated, differences compromised, and doubtful questions settled by agreement. Other types of data, criteria, or standards may furnish equally reliable guides to fair compensation. The amount of record keeping, reporting and accounting, in connection with the settlement of termination claims, shall be kept to the minimum compatible with the reasonable protection of the public interest. [32 CFR 8.301]

SEC. 8.303 *Allowance for profit.* (a) *General.* Profit shall be allowed only on preparations made and work done by the contractor for the terminated portion of the contract but may not be allowed on the contractor's settlement expenses. Anticipatory profits and consequential damages shall not be allowed (but see § 8.208-5). Any reasonable method may be used to arrive at a fair profit, separately or as a part of the whole settlement. [32 CFR 8.303]

SEC. 8.701 *Termination clause for fixed-price contracts.* Except as otherwise permitted by § 8.705, the following clause shall be used in any fixed-price contract in excess of $1,000 for supplies or experimental, developmental, or research work other than (a) construction, alterations, or repair of buildings, bridges, roads, or other kinds of real property, or (b) experimental, developmental or research work with educational or nonprofit institutions, where no profit is contemplated.

TERMINATION FOR CONVENIENCE OF THE GOVERNMENT

(a) The performance of work under this contract may be terminated by the Government in accordance with this clause in whole, or from time to time in part, whenever the Contracting Officer shall determine that such termination is in the best interests of the Government. Any such termination shall be effected by delivery to the Contractor of a Notice of Termination specifying the extent to which performance of work under the contract is terminated, and the date upon which such termination becomes effective.

(b) After receipt of a Notice of Termination, and except as otherwise directed by the Contracting Officer, the Contractor shall:

(1) Stop work under the contract on the date and to the extent specified in the Notice of Termination;

(2) Place no further orders or subcontracts for materials, services or facilities, except as may be necessary for completion of such portion of the work under the contract as is not terminated;

(3) Terminate all orders and subcontracts to the extent that they relate to the performance of work terminated by the Notice of Termination;

(4) Assign to the Government, in the manner, at the times, and to the extent directed by the Contracting Officer, all of the right, title, and interest of the Contractor under the orders and subcontracts so terminated, in which case the Government shall have the right, in its discretion, to settle or pay any or all claims arising out of the termination of such orders and subcontracts;

(5) Settle all outstanding liabilities and all claims arising out of such termination of orders and subcontracts, with the approval or ratification of the Contracting Officer, to the extent he may require, which approval or ratification shall be final for all the purposes of this clause;

(6) Transfer title and deliver to the Government, in the manner, at the times, and to the extent, if any, directed by the Contracting Officer, (A) the fabricated or unfabricated parts, work in process, completed work, supplies, and other material produced as a part of, or acquired in connection with the performance of, the work terminated by the Notice of Termination, and (B) the completed or partially completed plans, drawings, information and other property which, if the contract had been completed, would have been required to be furnished to the Government;

(7) Use its best efforts to sell, in the manner, at the times, to the extent, and at the price or prices directed or authorized by the Contracting Officer, any property

of the types referred to in (6) above, *Provided, however*, That the Contractor (A) shall not be required to extend credit to any purchaser, and (B) may acquire any such property under the conditions prescribed by and at a price or prices approved by the Contracting Officer. And *provided further*, That the proceeds of any such transfer or disposition shall be applied in reduction of any payments to be made by the Government to the Contractor under this contract or shall otherwise be credited to the price or cost of the work covered by this contract or paid in such other manner as the Contracting Officer may direct;

(8) Complete performance of such part of the work as shall not have been terminated by the Notice of Termination; and

(9) Take such action as may be necessary, or as the Contracting Officer may direct, for the protection and preservation of the property related to this contract which is in the possession of the Contractor and in which the Government has or may acquire an interest.

At any time after expiration of the plant clearance period, as defined in 32 CFR Part 8, as it may be amended from time to time, the Contractor may submit to the Contracting Officer a list, certified as to quantity and quality, of any or all items of termination inventory not previously disposed of, exclusive of items the disposition of which has been directed or authorized by the Contracting Officer, and may request the Government to remove such items or enter into a storage agreement covering them. Not later than fifteen (15) days thereafter, the Government will accept title to such items and remove them or enter into a storage agreement covering the same:

Provided, That the list submitted shall be subject to verification by the Contracting Officer upon removal of the items, or if the items are stored, within forty-five (45) days from the date of submission of the list, and any necessary adjustment to correct the list as submitted shall be made prior to final settlement.

(c) After receipt of a Notice of Termination, the Contractor shall submit to the Contracting Officer its termination claim, in the form and with certification prescribed by the Contracting Officer. Such claim shall be submitted promptly but in no event later than one year from the effective date of termination, unless one or more extensions in writing are granted by the Contracting Officer, upon request of the Contractor made in writing within such one year period or authorized extension thereof. However, if the Contracting Officer determines that the facts justify such action, he may receive and act upon any such termination claim at any time after such one year period or any extension thereof. Upon failure of the Contractor to submit its termination claim within the time allowed, the Contracting Officer may, subject to any Settlement Review Board approvals required by 32 CFR Part 8 in effect as of the date of execution of this contract, determine, on the basis of information available to him, the amount, if any, due to the Contractor by reason of the termination and shall thereupon pay to the Contractor the amount so determined.

(d) Subject to the provisions of paragraph (c), and subject to any Settlement Review Board approvals required by 32 CFR Part 8 in effect as of the date of execution of this contract, the Contractor and the Contracting

Officer may agree upon the whole or any part of the amount or amounts to be paid to the Contractor by reason of the total or partial termination of work pursuant to this clause, which amount or amounts may include a reasonable allowance for profit on work done: *Provided*, That such agreed amount or amounts, exclusive of settlement costs, shall not exceed the total contract price as reduced by the amount of payments otherwise made and as further reduced by the contract price of work not terminated. The contract shall be amended accordingly, and the Contractor shall be paid the agreed amount. Nothing in paragraph (e) of this clause, prescribing the amount to be paid to the Contractor in the event of failure of the Contractor and the Contracting Officer to agree upon the whole amount to be paid to the Contractor by reason of the termination of work pursuant to this clause, shall be deemed to limit, restrict, or otherwise determine or affect the amount or amounts which may be agreed upon to be paid to the Contractor pursuant to this paragraph (d).

(e) In the event of the failure of the Contractor and the Contracting Officer to agree as provided in paragraph (d) upon the whole amount to be paid to the Contractor by reason of the termination of work pursuant to this clause, the Contracting Officer shall, subject to any Settlement Review Board approvals required by 32 CFR Part 8 in effect as of the date of execution of this contract, determine, on the basis of information available to him, the amount, if any, due to the Contractor by reason of the termination and shall pay to the Contractor the amounts determined as follows:

(1) For completed supplies accepted by the Government (or sold or acquired as provided in paragraph (b) (7) above) and not theretofore paid for, a sum equivalent to the aggregate price for such supplies computed in accordance with the price or prices specified in the contract, appropriately adjusted for any saving of freight or other charges;

(2) The total of—

(A) The costs incurred in the performance of the work terminated, including initial costs and preparatory expense allocable thereto, but exclusive of any costs attributable to supplies paid or to be paid for under paragraph (e) (1) hereof;

(B) The cost of settling and paying claims arising out of the termination of work under subcontracts or orders, as provided in paragraph (b) (5) above, which are properly chargeable to the terminated portion of the contract, exclusive of amounts paid or payable on account of supplies or materials delivered or services furnished by subcontractors or vendors prior to the effective date of the Notice of Termination, which amounts shall be included in the costs payable under (A) above; and

(C) A sum, as a profit, equal to 2 percent of that part of the amount determined under (A) above which represents the cost of articles and materials not processed by the Contractor, plus a sum equal to 8 percent of the remainder of such amount, but the aggregate of such sums shall not exceed 6 percent of the whole of the amount determined under (A) above, which amount for the purpose of this subdivision (C) shall exclude any

charges for interest on borrowings: *Provided, however,* That if it appears that the Contractor would have sustained a loss on the entire contract had it been completed, no profit shall be included or allowed under this subdivision (C) and an appropriate adjustment shall be made reducing the amount of the settlement to reflect the indicated rate of loss; and

(3) The reasonable costs of settlement, including accounting, legal, clerical, and other expenses reasonably necessary for the preparation of settlement claims and supporting data with respect to the terminated portion of the contract and for the termination and settlement of subcontracts thereunder, together with reasonable storage, transportation, and other costs incurred in connection with the protection or disposition of property allocable to this contract.

The total sum to be paid to the Contractor under (1) and (2) of this paragraph (e) shall not exceed the total contract price as reduced by the amount of payments otherwise made and as further reduced by the contract price of work not terminated. Except for normal spoilage, and except to the extent that the Government shall have otherwise expressly assumed the risk of loss, there shall be excluded from the amounts payable to the Contractor as provided in (e) (1) and (2) (A) above, the fair value, as determined by the Contracting Officer, of property which is destroyed, lost, stolen, or damaged so as to become undeliverable to the Government, or to a buyer pursuant to paragraph (b) (7).

(f) Any determination of costs under paragraph (e) or (e) thereof shall be governed by the principles for

consideration of costs set forth in 32 CFR 8.302, as in effect on the date of this contract.

(g) The Contractor shall have the right of appeal, under the clause of this contract entitled "Disputes," from any determination made by the Contracting Officer under paragraph (c) or (e) above, except that if the Contractor has failed to submit its claim within the time provided in paragraph (c) above and has failed to request extension of such time, it shall have no such right of appeal. In any case where the Contracting Officer has made a determination of the amount due under paragraph (c) or (e) above, the Government shall pay to the Contractor the following: (i) If there is no right of appeal hereunder or if no timely appeal has been taken, the amount so determined by the Contracting Officer, or (ii) if an appeal has been taken, the amount finally determined on such appeal.

(h) In arriving at the amount due the Contractor under this clause there shall be deducted (i) all unliquidated advance or other payments on account theretofore made to the Contractor, applicable to the terminated portion of this contract, (ii) any claim which the Government may have against the Contractor in connection with this contract, and (iii) the agreed price for, or the proceeds of sale of, any materials, supplies, or other things acquired by the Contractor or sold, pursuant to the provisions of this clause, and not otherwise recovered by or credited to the Government.

(i) If the determination hereunder be partial, prior to the settlement of the terminated portion of this contract, the Contractor may file with the Contracting Of-

ficer a request in writing for an equitable adjustment of the price or prices specified in the contract relating to the continued portion of the contract (the portion not terminated by the Notice of Termination), and such equitable adjustment as may be agreed upon shall be made in such price or prices.

(j) The Government may from time to time, under such terms and conditions as it may prescribe, make partial payments and payments on account against costs incurred by the Contractor in connection with the terminated portion of this contract whenever in the opinion of the Contracting Officer the aggregate of such payments shall be within the amount to which the Contractor will be entitled hereunder. If the total of such payments is in excess of the amount finally agreed or determined to be due under this clause, such excess shall be payable by the Contractor to the Government upon demand, together with interest computed at the rate of 6 percent per annum, for the period from the date such excess payment is received by the Contractor to the date on which such excess is repaid to the Government: *Provided, however,* That no interest shall be charged with respect to any such excess payment attributable to a reduction in the Contractor's claim by reason of retention or other disposition of termination inventory until ten days after the date of such retention or disposition, or such later date as determined by the Contracting Officer by reason of the circumstances.

(k) Unless otherwise provided for in this contract, or by applicable statute, the Contractor, from the effective date of termination and for a period of three years after

final settlement under this contract, shall preserve and make available to the Government at all reasonable times at the Office of the Contractor but without direct charge to the Government, all its books, records, documents, and other evidence bearing on the costs and expenses of the Contractor under this contract and relating to the work terminated hereunder, or to the extent approved by the Contracting Officer, photographs, micro-photographs or other authentic reproductions thereof. [32 CFR 8.701]

APPENDIX C

TERMINATIONS
OF
MILITARY PRIME CONTRACTS

July 1959 - June 1960

Prepared for
Office of the Assistant Secretary of Defense
(Supply and Logistics)

by
Statistical Services Center, OSD

TERMINATIONS OF MILITARY PRIME CONTRACTS FOR CONVENIENCE OF THE GOVERNMENT

Summary. The second half of fiscal year 1960 was characterized by an increase over the first half in the number of [illegible] terminated and the number of cases settled. However, the [illegible] items terminated (CPIT) declined from $[illegible] in the first half to $291,147,000 in the second, while the CPIT of [illegible] settled increased from $360,263,000 to $394,736,000.

In fiscal year 1960 as a whole there were [illegible],946 partial or total cancellations of military prime contracts for the convenience of the Government, compared to 4,864 cases in fiscal year 1959. The contract price of items terminated in fiscal year 1960 amounted to $1,096,000,000 or $117,000,000 more than the amount cancelled in the preceding fiscal year. Although the number of settlements of terminated contracts also was higher in fiscal year 1960 than in fiscal year 1959 (5,551 against 4,952), the CPIT of settlements was substantially lower ($755,000,000 compared to $1,095,000,000). These figures are shown by fiscal year in Chart I and by Department in Table 1.

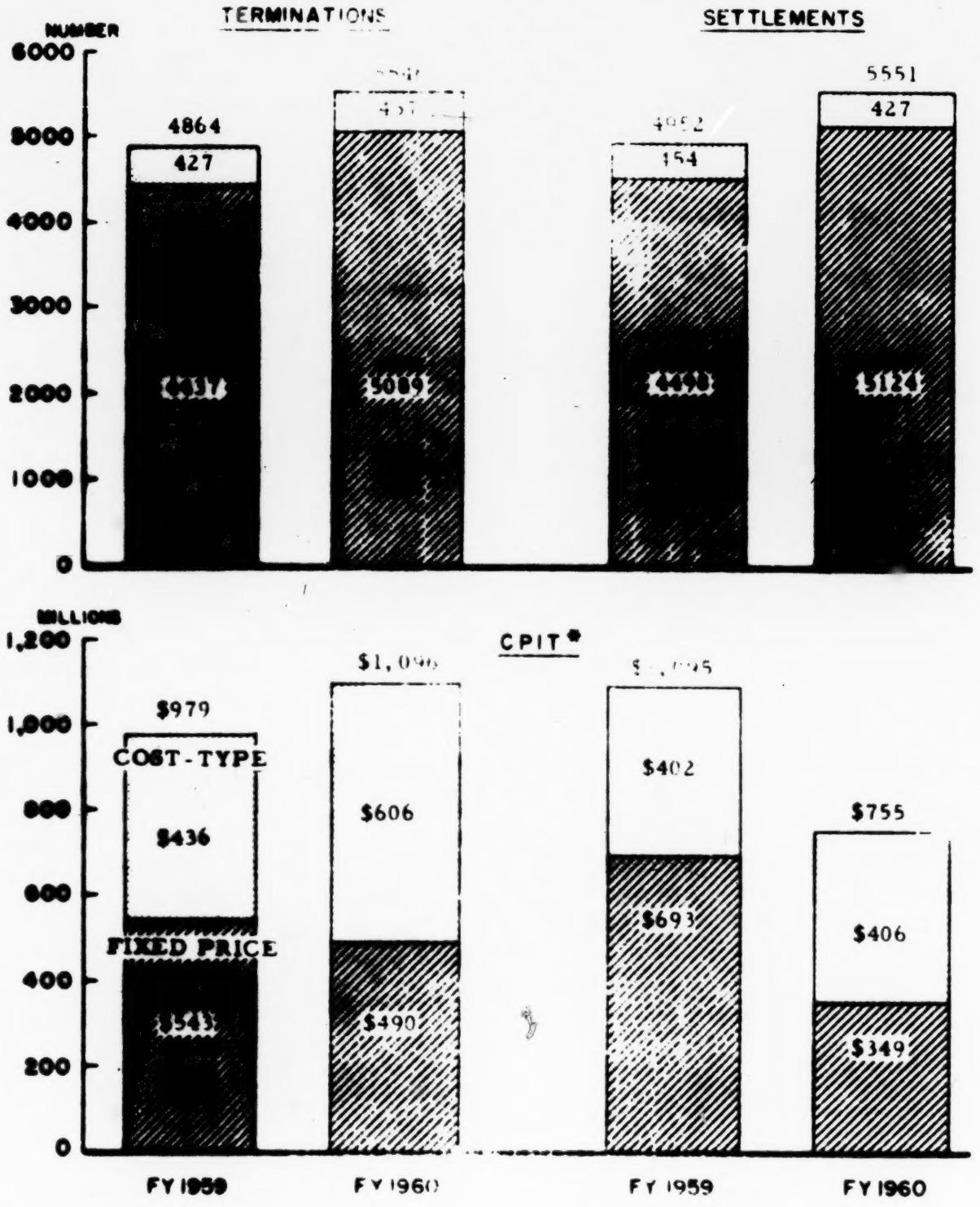
Table 1

TERMINATIONS AND SETTLEMENTS OF MILITARY PRIME CONTRACTS TERMINATED FOR THE CONVENIENCE OF THE GOVERNMENT

Fiscal Years 1959 and 1960

	FY 1959 (Jul 1958-Jun 1959)	FY 1960		
		Total	Jul-Dec 1959	Jan-Jun 1960
NUMBER OF ACTIONS				
Terminations (Total)	4,9[illegible]	5,2[illegible]6	[illegible]	[illegible]
Army	[illegible],39[illegible]	[illegible]	[illegible]	824
Navy	[illegible],303	[illegible]	[illegible]	[illegible],578
Air Force	[illegible],[illegible]48	[illegible]	[illegible]	561
Settlements (Total)	4,952	5,551	2,537	3,014
Army	[illegible],377	1,489	612	874
Navy	1,[illegible]42	[illegible],[illegible]41	1,398	1,645
Air Force	1,127	[illegible]	527	495
CONTRACT PRICE OF ITEMS TERMINATED ($000)				
Terminations (Total)	$ [illegible]72,203	$1,096,331	$805,184	$291,147
Army	72,451	127,594	95,167	32,427
Navy	348,071	223,185	178,280	34,905
Air Force	558,586	755,552	531,737	223,815
Settlements (Total)	[illegible],[illegible]62,[illegible]71	[illegible],[illegible]29	[illegible],[illegible]63	394,736
Army	45,282	[illegible],[illegible]87	29,326	30,761
Navy	280,025	[illegible],[illegible]29	74,237	86,850
Air Force	769,269	[illegible],[illegible]12	[illegible],[illegible]74	277,125

FIXED-PRICE AND COST-TYPE MILITARY PRIME CONTRACT TERMINATIONS AND SETTLEMENTS

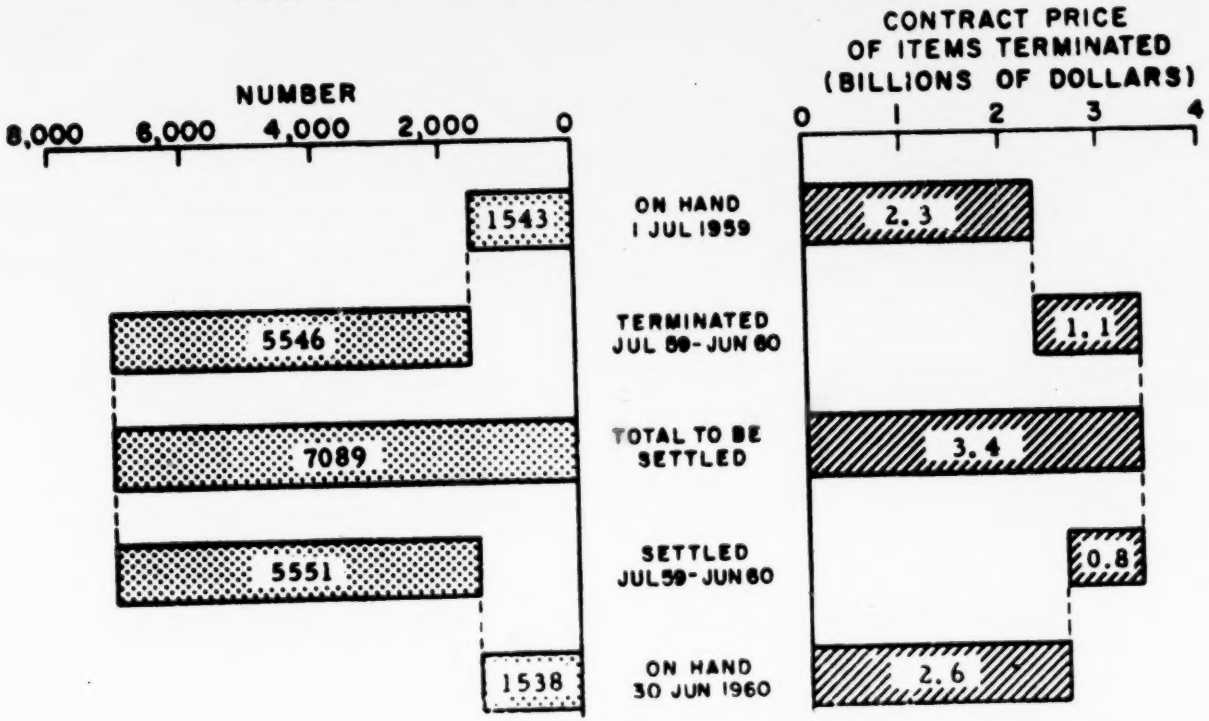


*CONTRACT PRICE OF ITEMS TERMINATED

As may be seen in the following chart, the number of cases awaiting settlement on July 1, 1959 and June 30, 1960 was virtually unchanged. However, the CPIT of pending cases rose from $2,300,000,000 to $2,643,000,000.

Chart II

MILITARY PRIME CONTRACT TERMINATIONS FOR CONVENIENCE OF THE GOVERNMENT



Of the 1,538 cases awaiting settlement on June 30, 1960, 1,091 or 71% were fixed price contracts and the remainder were cost-reimbursement type contracts. Fixed price contracts accounted for 60% of the CPIT value of these pending cases. The average terminated amount of pending fixed price contracts was $1,457,000 compared to $2,357,000 for cost-reimbursement type contracts.

Table 2

SUMMARY OF MILITARY PRIME CONTRACTS TERMINATED FOR CONVENIENCE OF THE GOVERNMENT

July 1959 - June 1960

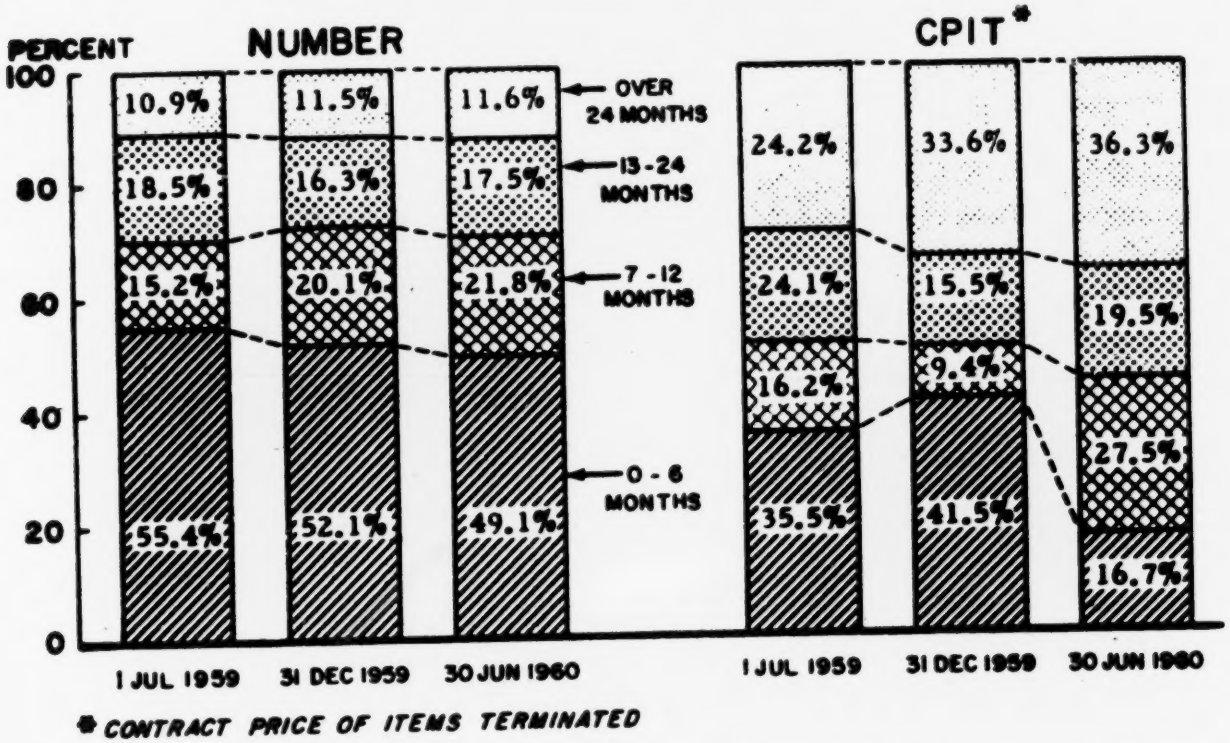
Status	Number of Terminations			Contract Price of Items Terminated ($000)		
	Total	Fixed Price	Cost Type	Total	Fixed Price	Cost Type
Pending on 1 July 1959 (Total)	1,543	1,126	417	$2,301,992	$1,448,066	$ 853,926
Army	341	227	114	588,918	524,679	64,239
Navy	636	483	153	849,299	559,659	289,640
Air Force	566	416	150	863,775	363,728	500,047
Terminated, Jul 1959-June 1960 (Total)	5,546	5,089	457	1,096,331	490,445	605,886
Army	1,441	1,329	112	127,594	93,609	33,985
Navy	2,956	2,876	80	213,185	128,403	84,782
Air Force	1,149	884	265	755,552	268,433	487,119
Settled, Jul 1959-June 1960 (Total)	5,551	5,124	427	754,999	348,697	406,302
Army	1,486	1,378	108	57,087	34,061	23,026
Navy	3,043	2,944	99	161,087	134,332	26,755
Air Force	1,022	802	220	536,825	180,304	356,521
Pending on 30 June 1960 (Total)	1,538	1,091	447	2,643,324	1,589,814	1,053,510
Army	296	178	118	659,425	584,227	75,198
Navy	549	415	134	901,397	553,730	347,667
Air Force	693	498	195	1,082,502	451,857	630,645

Age of Pending Cases - About 70% of the cases awaiting settlement on June 30, 1960 were not more than 12 months old from the effective date of termination. These cases had a CPIT value of $1,168,000,000 or 44% of the total backlog.

Cases pending over 2 years accounted for almost 12% of the number and 36% of the CPIT. As mentioned in the preceding report, older cases involve substantial problems of inventory disposal and subcontractor settlements. In a number of instances, review before the Armed Services Board of Contract Appeals, or litigation is involved. Table 3 shows the cases pending on June 30, 1960 by age group, department and type of contract, and Chart III compares the percentage distribution by age group for the periods July 1, 1959, January 1, 1960 and June 30 1960.

Chart III

AGE OF MILITARY PRIME CONTRACT TERMINATIONS AWAITING SETTLEMENT



* CONTRACT PRICE OF ITEMS TERMINATED

Table 3

AGE OF PENDING MILITARY PRIME CONTRACTS TERMINATED FOR CONVENIENCE OF THE GOVERNMENT

As of June 30, 1960

Age from Effective Date of Termination	Number of Terminations			Contract Price of Items Terminated ($000)		
	Total	Fixed Price	Cost Type	Total	Fixed Price	Cost Type
Pending on June 30, 1960 (Total)	[illegible]	[illegible]	[illegible]	$2,643,324	$1,589,814	$1,053,510
Army	[illegible]	[illegible]	118	659,425	584,227	75,198
Navy	[illegible]	[illegible]	[illegible]	901,397	553,730	347,667
Air Force	693	[illegible]	195	1,082,502	451,857	630,645
6 Months Old or Less (Total)	[illegible]	[illegible]	[illegible]	[illegible]	119,188	322,552
Army	[illegible]	[illegible]	[illegible]	30,399	17,452	12,947
Navy	149	[illegible]	30	26,812	22,981	3,831
Air Force	488	[illegible]	145	384,529	78,755	305,774
Over 6 Months Thru 12 Months (Total)	336	236	100	726,213	323,184	403,029
Army	75	40	35	85,515	67,267	18,248
Navy	124	98	26	166,906	86,655	80,251
Air Force	137	98	39	473,792	169,262	304,530
Over 12 Months Thru 24 Months (Total)	[illegible]	[illegible]	91	[illegible]	[illegible]	223,643
Army	88	34	32	73,817	30,610	43,207
Navy	162	[illegible]	53	282,404	102,934	179,470
Air Force	[illegible]	[illegible]	6	160,284	159,318	966
Over 24 Months (Total)	[illegible]	[illegible]	37	958,866	[illegible]	104,286
Army	37	30	7	469,694	[illegible]	796
Navy	114	89	25	425,275	341,160	84,115
Air Force	27	[illegible]	5	63,897	44,522	19,375

Settlements of Fixed Price Contract Terminations. Over four fifths of the settlements of fixed-price contract terminations in fiscal year 1960 involved no cost to the Government. As might be expected these were the smaller, less complicated cases, and these, alone, accounted for only one-fifth of the CPIT of all fixed-price cases settled during the year. Settlement costs agreed to by the Government amounted to $46,478,000, or 13% of the CPIT amount of fixed-price cases settled in fiscal year 1960.

When a cost reimbursement type contract is terminated, the contractor may (and usually does) elect to continue the submission of vouchers (Standard Form 1034) for costs incurred. Usually, therefore, the settlement consists of an adjustment of the fee only. For this reason, settlement data for cost-reimbursement type contract terminations are not comparable with those for fixed-price contracts and are not shown in this report.

Table 4

SETTLEMENT OF FIXED-PRICE MILITARY PRIME CONTRACTS
TERMINATED FOR CONVENIENCE OF THE GOVERNMENT

Fiscal Year 1960

Status	Total	Jul-Dec 1959	Jan - Jun 1960, by Department			
			Total	Army	Navy	Air Force
NUMBER OF CASES						
Settled (Total)	5,124	2,347	2,777	802	1,585	390
Settled at No Cost to Government	4,311	1,940	2,371	690	1,447	234
% of No Cost Settlements to Total	84.1%	82.7%	85.4%	86.0%	91.3%	60.0%
CPIT OF CASES (In Thousands)						
Settled (Total)	$348,696	$164,092	$184,604	$18,678	$67,144	$98,782
Settled at No Cost to Government	69,352	40,354	28,998	3,620	3,807	21,571
% of No Cost Settlements to Total	19.9%	24.6%	15.7%	19.4%	5.7%	21.8%
SETTLEMENT COST						
Amount (In Thousands)	$ 46,478	$ 29,881	$ 16,597	$ 3,968	$ 4,472	$ 8,157
% of Settlement Cost to CPIT	13.3%	18.2%	9.0%	21.2%	6.7%	8.3%

CPIT - Contract price of items terminated.

Settlement Proposals Received Against Pending Fixed-Price Contract Terminations.

On June 30, 1960 there were 1,091 fixed-price cases awaiting settlement of which contractors' settlement proposals were on hand for 406 cases, or 37%. These 406 cases accounted for 59% of the CPIT value of all fixed-price cases awaiting settlement.

The gross amount of the 406 settlement proposals on hand was $105,048,000, which represented 11% of the CPIT value of these cases. In anticipation of final settlement of these proposals, partial payments of $36,443,000 or one-third of the claimed amount had been made by June 30, 1960.

Table 5

[illegible] SETTLEMENT PROPOSALS ON
[illegible] MILITARY PRIME CONTRACTS
[illegible] BY THE GOVERNMENT

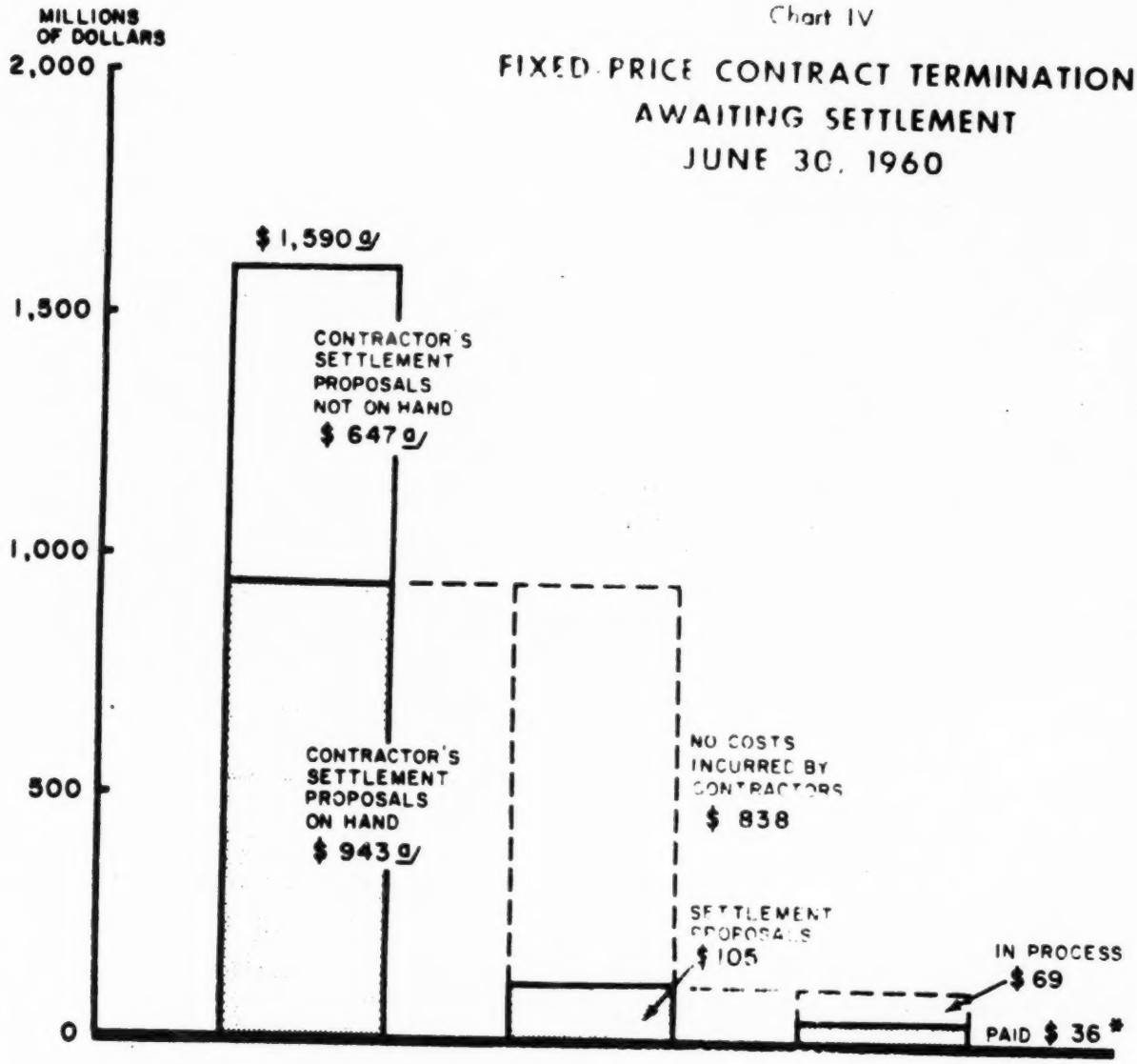
As of December [illegible] and June 30, 1960

[illegible]	[illegible]	June 30, 1960 by Department			
		Total	Army	Navy	Air Force
NUMBER OF CASES					
Awaiting Settlement (Total)	[illegible]	[illegible]	178	415	498
Without Settlement Proposals	[illegible]	685	72	313	300
With Settlement Proposals	806	406	106	102	198
% of Total with Settlement Proposals	[illegible]%	[illegible]%	59.6%	24.6%	39.8%
CPIT OF CASES (In Thousands)					
Awaiting Settlement (Total)	$ [illegible]	$1,989,815	$584,227	$553,730	$451,858
Without Settlement Proposals	[illegible]	[illegible]	104,232	259,236	283,431
With Settlement Proposals	889,570	943,916	479,995	294,494	168,427
% of Total with Settlement Proposals	[illegible]%	59.3%	82.2%	53.2%	37.3%
CONTRACTORS' SETTLEMENT PROPOSALS					
Amount (In Thousands)	$ [illegible]	$ [illegible]	$ [illegible]	$ 26,168	$ 49,598
% of CPIT	[illegible]%	[illegible]%	6.1%	8.9%	29.4%
PARTIAL PAYMENTS AGAINST SETTLEMENT PROPOSALS					
Amount (In Thousands)	$ [illegible]	$ 36,443	$ 9,859	$ 6,570	$ 20,014
% of Settlement Proposals	[illegible]%	34.7%	33.7%	25.1%	40.4%

CPIT - Contract price of items terminated

Chart IV

FIXED PRICE CONTRACT TERMINATIONS AWAITING SETTLEMENT JUNE 30, 1960



* PARTIAL PAYMENTS MADE AGAINST SETTLEMENT PROPOSALS

g/ CONTRACT PRICE OF ITEMS TERMINATED

Terminations of Military Prime Contracts for Default. The number of new terminations for default in fiscal year 1960 was 1,179 compared with 1,159 cases settled. Accordingly, the number of pending cases increased by 20 to 292 at the end of the fiscal year. However, in CPIT terms, the settlement amounted to $34,345,000 against $31,035,000 of new terminations, so that during the year the CPIT backlog decreased by $3,300,000 to $28,826,000 on June 30, 1960.

Table 6

SUMMARY OF MILITARY PRIME CONTRACTS TERMINATED FOR DEFAULT

Fiscal Year 1960

Status	Number of Terminations			Contract Price of Items Terminated ($000)		
	Total	Jul-Dec 1959	Jan-Jun 1960	Total	Jul-Dec 1959	Jan-Jun 1960
Pending at Beginning of Period (Total)	272	272	282	$32,136	$32,136	$26,974
Army	163	163	163	15,784	15,784	17,176
Navy	43	43	43	3,150	3,150	2,090
Air Force	86	86	76	13,202	13,202	7,708
Terminated During Period (Total)	1,179	502	677	31,035	10,622	20,413
Army	782	306	476	10,105	3,744	6,361
Navy	219	117	102	2,400	1,169	1,231
Air Force	178	80	99	18,530	5,709	12,821
Settled During Period (Total)	1,159	492	667	34,345	15,784	18,561
Army	769	289	480	9,406	2,352	7,054
Navy	218	114	104	4,359	2,229	2,130
Air Force	172	89	83	20,580	11,203	9,377
Pending End of Period (Total)	292	282	292	28,826	26,974	28,826
Army	159	163	159	16,483	13,176	16,483
Navy	41	43	41	1,191	2,090	1,191
Air Force	92	76	92	11,152	7,708	11,152

COVERAGE AND DEFINITIONS

This report covers terminated contracts processed by central purchasing type offices of the technical services, bureaus and commands. It does not include terminations of local or housekeeping purchases by posts, camps, stations, and bases.

Definitions of terms used in this report are as follows:

Military Prime Contract - A contract entered into directly by a military department or agency.

Fixed-Price Contract - One which generally specifies a firm price, or under certain circumstances, an adjustable price, for the items or services to be provided under the contract.

Cost-Reimbursement Contract - One which provides for payment to the contractor of allowable costs incurred in the performance of the contract.

Termination for Convenience of the Government - Discontinuance, other than for default of all or part of the work to be performed under a contract. This type of termination is usually associated with reprogramming of procurement requirements.

Termination for Default of Contractor - Cancellation of a contract because the contractor has failed to perform or make progress in accordance with the provisions of the contract.

Contract Price of Items (or Services) Terminated - Amount of cancelled portion of contracts, abbreviated to "CPIT" in this report. At the time of termination, this amount is generally a broad estimate which is subject to revision when definitive reports are filed by the contractor.

Amount of Settlement Proposal or Claim - Gross amount claimed by the contractor as reimbursement for costs and expenses incurred as a result of the termination, including profit.

Amount of Settlement - Amount of settlement proposal or claim which is mutually agreed upon by the contractor and the Government, less disposal credits. A termination for convenience is settled when a supplemental agreement to the basic contract is executed by the contractor and Government. A termination for default is settled when (1) no repurchase is required, (2) a repurchase does not involve excess costs, (3) excess costs of a repurchase are paid by the defaulted contractor, or (4) the case is referred to another Department for collection.

Partial Payment - Amount paid by the Government to a contractor for the benefit of that contractor or his subcontractors after submission of an interim or final settlement proposal, but prior to final settlement of the terminated contract.

INDEX

	Page
Opinion below	1
Jurisdiction	1
Question presented	2
Statute and Regulations involved	2
Statement	4
Argument	8
Conclusion	14

CITATIONS

Cases:

Commissioner v. *Dumari Textile Co.*, 142 F 2d 897	9
Commissioner v. *Fifth Avenue Coach Lines, Inc.*, 281 F 2d 556, reversing 31 T.C. 1080	13
Continental Tie & L. Co. v. *United States*, 286 U.S. 290	9-10, 11, 12
Hotchkiss v. *National City Bank of New York*, 200 Fed. 287	13
Lucas, H., & Co. v. *Commissioner*, 90 F 2d 932	9
Security Mills Co. v. *Commissioner*, 321 U.S. 281	9
Spring City Co. v. *Commissioner*, 292 U.S. 182	9, 11

Statutes:

Contract Settlement Act of 1944, c. 358, 58 Stat. 649	4, 9
Internal Revenue Code of 1939:	
Sec. 41 (26 U.S.C. 1952 ed., Sec. 41)	2, 8
Sec. 42 (26 U.S.C. 1952 ed., Sec. 42)	2
Sec. 435(a) (26 U.S.C. 1952 ed., Sec. 435(a))	8
Sec. 435(b) (26 U.S.C. 1952 ed., Sec. 435(b))	8

Miscellaneous:

Min. 5897, 1945 Cum. Bull 131	11
Rev. Rul. 55-205, 1955-1 Cum. Bull 325	11
Treasury Regulations 111 (1939 Code), Sec. 29.42-1	3, 11

In the Supreme Court of the United States

OCTOBER TERM, 1961

No. 118

FOOD MACHINERY AND CHEMICAL CORPORATION, a corporation, PETITIONER

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinions (Pet. 23-44) of the Court of Claims are reported at 286 F.2d 177. The court's findings of fact are reprinted at Pet. 45-72.

JURISDICTION

The Court of Claims judgment dismissing the taxpayer's petition was entered on December 1, 1960. (Pet. 23, 42.) Taxpayer's motion for rehearing was filed on December 27, 1960, and denied on March 1, 1961. The petition for a writ of certiorari was filed on May 26, 1961. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1255(1).

QUESTION PRESENTED

Whether the Court of Claims correctly held that petitioner, an accrual-basis taxpayer, had a fixed right, in its fiscal year 1945, to receive reasonably ascertainable amounts of profit allowances with respect to terminated government war contracts and was therefore obliged to report those amounts as income in that year.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; * * *.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42. [As amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

(26 U.S.C. 1952 ed., Sec. 42.)

Treasury Regulations 111 (1939 Code):

Sec. 29.42-1. [As amended by T.D. 5405, 1944 Cum. Bull. 154] *When Included in Gross Income.*—(a) *In general.*—Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. * * * Except as otherwise stated in this subsection, such items as claims for compensation under canceled Government contracts constitute income for the year in which they are allowed or their value is otherwise definitely determined, if the return is rendered on the accrual basis; or for the year in which received, if the return is rendered on the basis of cash receipts and disbursements. In the case of a termination of a war contract as defined by section 3 of the Contract Settlement Act of 1944 (or the termination of any other Government contract as to which the right to compensation is definitely fixed and the measure thereof is determinable with reasonable accuracy), if the return is rendered on a basis other than cash receipts and disbursements, compensation for the termination shall, unless a different method of reporting is prescribed or approved by the Commissioner, constitute income for the taxable year in which falls the effective date of the termination, except that if any part of the compensation is attributable to cost, expenses, or losses incurred in a subsequent year such part of the compensation shall be returned as income for the subsequent year.

* * * * *

STATEMENT

The taxpayer, a corporation reporting on the accrual basis of accounting and for the fiscal year ending September 30, 1945, manufactured (during World War II) amphibian tanks and spare parts as a prime contractor under fixed-price contracts with the Navy Department. Between November, 1943, and July, 1945, it entered into eleven contracts, all of which were war contracts as defined by the Contract Settlement Act of 1944, c. 358, 58 Stat. 649. (Pet. 24.)

Taxpayer's records indicated the materials purchased for each contract, but items common to several contracts were physically commingled. Its records did not disclose the amount of work in process and only a physical inventory could have determined that amount. The taxpayer made no effort to take such an inventory. (Pet. 25.)

The taxpayer became aware, early in 1945, that its contracts might be terminated, and in late June and early July, 1945, pre-termination conferences were held between the taxpayer's representatives and Captain Rosenstein, the contracting officer in charge of taxpayer's contracts, and other representatives of the Bureau of Ships. The conferees agreed on a profit rate of 4.875 per cent, on the basis of which the taxpayer was to submit its termination claims. (Pet. 25-26.)

On July 19, 1945, the Bureau of Ships submitted a draft pre-termination agreement relating to five contracts. The draft provided, *inter alia*, for a 4.875 per cent rate of profit. The taxpayer did not reply to the draft and no agreement was executed. Between

July 20 and August 30, 1945, all of the taxpayer's eleven contracts were terminated by termination notices under the provisions of the Contract Settlement Act of 1944 and the Joint Termination Regulations; the war ended on August 14, 1945. (Pet. 25-26.)

After receiving the termination notices, taxpayer stopped work and notified suppliers and subcontractors to stop work. Work in process was reviewed with Navy representatives and disposition of some of this material, *e.g.*, scrapping semi-fabricated pieces, was determined and approved by the Navy. As a result of these dispositions of work in process, when taxpayer's inventory was taken it was not possible to distinguish between purchased parts and raw materials on the one hand and work in process on the other. (Pet. 26-27.)

With Captain Rosenstein's permission, taxpayer filed two joint inventory and settlement proposals, each covering four of the terminated contracts. On September 18, 1945, taxpayer's president and the Captain reached an understanding that the 4.875 per cent profit rate remained mutually agreeable and would be claimed by the taxpayer and allowed by the Captain. Captain Rosenstein confirmed this understanding by letter dated September 21, 1945. It was also understood that the profit rate was subject to review by the Government's Settlement Review Board in Washington. (Pet. 27.)

On or about November 26, 1945, Captain Rosenstein orally granted taxpayer's request to submit one settlement proposal covering all of its terminated contracts, apportioning charges *pro rata*, and on November 27

the taxpayer filed its first settlement proposal. The Supervisor of Shipbuilding confirmed the authorization by letter dated December 7. The claim stated a total inventory of metals, purchased parts, finished components, and work in process of $18,618,592.43. At the 4.875 per cent rate of profit, taxpayer claimed a profit of $907,656.38. (Pet. 27-28.)

The claim was received by the Bureau of Ships' Contract Termination Section in Washington on or about January 3, 1946, with a report dated December 14, 1945, from the Supervisor of Shipbuilding. The report stated that Navy personnel had examined the inventories and checked prices and that materials were found in good condition and properly allocable to the terminated contracts. The report referred to such questionable items in the claim as taxpayer's failure to deduct cash discounts from costs and indicated that no adjustment was required because taxpayer had waived other items of cost. The report further noted that the profit rate requested was based on the rate agreed on at the September 18, 1945, meeting and that purchased parts constituted a larger percentage of total inventories than appeared to have been anticipated during negotiations on the profit rate. (Pet. 28.)

On January 8, 1946, at a meeting with the Navy representatives, the taxpayer was asked to apply for partial payment of its claim. Although taxpayer refused to apply, partial payment of $18,500,000 was tendered to and accepted by taxpayer's president on January 10. This represented about 95 per cent of taxpayer's total claim; the payment did not represent any allowance for profit or disposal credits and was

less than the sum claimed for inventories. At the January 8 meeting, taxpayer was also asked to supply data explaining the variation between the estimated amount of work in process and the amount reflected in taxpayer's claim. Taxpaper made an explanation by letter in February. (Pet. 28-29.)

On March 26, 1946, Captain Rosenstein submitted to the Settlement Review Board written proposals for settling taxpayer's claim. Except for freight charges of $21,222, he recommended that taxpayer's claim be accepted as submitted; taxpayer's claim for profit was reduced about $1,000 by that adjustment, *i.e.*, to $906,621.81. The Board approved the settlement on March 27, 1946, and the Chief of the Bureau of Ships approved the Board's action. After execution of documents relating to the termination claim, payments of the amounts due on the claim (minus the January 10, 1946, payment of $18,500,000) were made on June 12 and 13, 1946. Final disposition of other claims filed on behalf of subcontractors was made on January 9, 1947, by execution of final contracts and final payment to taxpayer. In the final settlement, the profit of $906,621.81 allowed on taxpayer's first claim was approved. (Pet. 29-30.)

The $906,621.81 allowed taxpayer as profit on its terminated contracts was included in taxpayer's return for its fiscal year ending September 30, 1945. Taxpayer filed a timely claim for refund of income and excess profits taxes of $652,767.67 on the ground that its profit allowance was not properly includible in income for fiscal 1945. The Commissioner disallowed the claim and the taxpayer timely filed a petition for

refund of the taxes in the Court of Claims.[1] (Pet. 30-31.)

The Court of Claims (one judge dissenting) held that under the Contract Settlement Act of 1944 the taxpayer had a right, upon termination of its contracts, to compensation for its material and labor expenditures and to a profit based on those costs. It found that the cost and inventory amounts to which taxpayer was entitled were reasonably ascertainable from taxpayer's books and that negotiations between the parties had reached a stage of sufficient agreement by the end of fiscal 1945 for the amount of its profit allowance to be considered reasonably ascertainable at that time. Accordingly, the court concluded that the taxpayer's profit allowance accrued as income during its taxable year ended September 30, 1945, and ordered taxpayer's petition dismissed. (Pet. 23-44.)

ARGUMENT

In holding that taxpayer's profit allowance was properly accruable as income of its fiscal year 1945, the Court of Claims followed accepted rules of accrual-basis tax accounting. There is no conflict and no occasion for further review.

1. Section 41 of the Internal Revenue Code of 1939, *supra*, p. 2, provides that net income shall be computed upon the basis of the taxpayer's annual accounting

[1] The inclusion of the $906,621.81 in income of fiscal 1945 is resisted by the taxpayer because 1946 income was not subject to the excess profits tax, and also because the amount of income in 1946 directly affects the excess profits credit available under 1939 Code Section 435(c) and (b), as amended, and thus affects its excess profits tax liability for 1950-1954.

period in accordance with the method of accounting regularly employed in keeping its books. Under the accrual basis of accounting, income is accruable in the year in which the taxpayer has a fixed right to receive a reasonably ascertainable amount. *Spring City Co.* v. *Commissioner*, 292 U.S. 182, 184-185; *Security Mills Co.* v. *Commissioner*, 321 U.S. 281, 286-287; *Commissioner* v. *Bamari Textile Co.*, 142 F. 2d 897 (C.A. 2d); *H. Liebes & Co.* v. *Commissioner*, 90 F. 2d 932 (C.A. 9th).

The taxpayer entered into war contracts which were terminated under the provisions of the Contract Settlement Act of 1944, c. 358, 58 Stat. 649. (Pet. 73-78.) Under Section 6 of that Act, it had a right to compensation for costs incurred under the terminated portions of the contracts for materials and labor as well as an allowance for profit on those costs. This right to compensation became fixed when the contracts were terminated by the Government.[2]

In deciding that the amount of income to which the taxpayer was entitled under the Settlement Act was reasonably ascertainable in taxpayer's fiscal year 1945, the court applied (Pet. 33-36, 39) the principles enunciated in *Continental Tie & L. Co.* v. *United States*, 286

---

[2] The taxpayer in its briefs below recognized that it had a *right* to compensation when the contracts were terminated, although it strenuously argued that the Settlement Act neither fixed the *amount* of its profit allowance nor provided a formula for determining that amount. The Court of Claims noted taxpayer's concession of this point and assumed that taxpayer's right to compensation was fixed under the Settlement Act in taxable year 1945. (Pet. 31, 33.) Taxpayer now seeks to raise a new issue in this Court by arguing that (Pet. 16) its "right to receive a profit allowance on its terminated contracts was not fixed by a binding final settlement until 1946".

U.S. 290. In that case, it was held that a railroad's right to an award under the Transportation Act of 1920 was fixed by the Act and that the Interstate Commerce Commission's function of ascertaining the amount of the award was ministerial. Furthermore, since all of the information on which the award was to be computed was contained in taxpayer's books and accounts, the Court held that the amount of the award could be ascertained within reasonable limits, even though the statute only formulated general principles and did not cover in detail the treatment of certain accounts with respect to which there might be a difference of opinion. It accordingly concluded that the amount of the award accrued in 1920, when the Act was passed, rather than in the year of payment.

The Court of Claims similarly found on the record before it that the inventory and cost amounts were ascertainable within reasonable limits before the close of taxpayer's fiscal year 1945. (Pet. 36.) It noted that the taxpayer's books and records contained the information from which the amount of inventory and other costs could be reasonably determined and that the question concerning the inventory accounts did not bar such a determination. In fact, the taxpayer, shortly after the close of its taxable year, filed its first settlement proposal covering inventory and other costs of some $18,618,592, which was accepted as submitted except for an adjustment of only $21,222. (Pet. 28-30.) The acceptance of the proposal squarely supports the conclusion that the inventory and other costs could be reasonably estimated.

Since under the Settlement Act the profit allowance is computed by taking a percentage of the inventory and costs, accrual of the allowance in 1945 depends further on whether the profit rate was reasonably settled in that year. The court below noted (Pet. 36-37) that the rate of profit was not an amount to be found in taxpayer's books and accounts and that to this extent the case was different from *Continental Tie*. However, in keeping with the principle that income accrues when the right to receive it is fixed and the amount can be reasonably estimated (*Spring City Co. v. Commissioner*, 292 U.S. 182), the court decided that the rate of profit had become sufficiently settled by negotiation prior to September 30, 1945, to permit the profit allowance to be ascertained within reasonable limits. (Pet. 37-40.) On this point, the court found that the profit rate had been tentatively agreed upon by the Navy and the taxpayer by July, 1945, and that the rate was confirmed prior to September 30, 1945, and not later disputed or reconsidered. (Pet. 38-39.) The court correctly

[illegible] (Contrary to taxpayer's assertion (Pet. 12-15) [illegible] concluded that the category [illegible] could be [illegible] taxpayer [illegible] ascertainable before the close of the 1945 [illegible] year, the court below applied an objective rather than a subjective [illegible] not only in *Continental Tie* but also in the [illegible] Act (Pet. 14-16). See also Section 29.42-1 of Treasury Regulations 111, *supra*, p. 3; Rev. Rul. 55-205, 1955-1 Cum. Bull. 325; Mim. 5897, 1945 Cum. Bull. 131. After correctly analyzing the evidence (Pet. 23-39), it concluded that (Pet. 40) under the facts and circumstances of this case negotiations between the parties had reached a stage of sufficient agreement by the end of April 1945 for the amount of plaintiff's profit allowance to be considered to be reasonably ascertainable at that time. It also noted (Pet. 37-38) that there was "no visible discord" between the parties as to the method of ascertaining the amount allowable.

held that the lack of a formal approval of the settlement agreement by the Settlement Review Board was not conclusive, in the circumstances, on the question whether the rate was reasonably ascertainable.[4]

2. The taxpayer advances three contentions in support of its petition.

The first (Pet. 12-15) is that the Court of Claims applied a "subjective expectancy-of-settlement test" in holding that the income accrued in fiscal 1945. Taxpayer's argument is apparently based on its erroneous statement (Pet. 11, 15) that the court deemed the reasoning of *Continental Tie* inapplicable to the case at bar and thus turned to what the taxpayer describes as a subjective test. Although the court observed that the instant case was factually different from *Continental Tie* because here it was necessary to go outside of the taxpayer's books and records to find whether the amount to be accrued was reasonably ascertainable, it applied the principles there laid down to the facts of this case. Thus, in order to determine whether the amount was reasonably ascertainable in 1945, it examined the evidence of agreement between the parties, such as conversations and communications passing between them, and the absence of discussions relating to a new profit rate. (Pet. 38-40.) It did not examine or rely on evidence of uncommunicated thoughts and

[4] Judge Whitaker's dissent (Pet. 42-44) was based on the ground that the profit rate was not determined until a binding settlement had been reached. The dissent, however, failed to recognize that the standard for accruing income is whether the amount of income can be reasonably ascertained—not whether the amount is fixed and known exactly.

intents of either party, the usual indicia of a subjective test. See *Commissioner* v. *Fifth Avenue Coach Lines, Inc.*, 281 F.2d 556 (C.A. 2d), reversing in part 31 T.C. 1080; *Hotchkiss* v. *National City Bank of New York*, 200 Fed. 287, 293 (S.D. N.Y.). Its finding that the amount of profit allowance was reasonably ascertainable was based on the "objective" circumstances shown by the record before it.

The second ground urged (Pet. 15-18) is that taxpayer had no fixed right to a profit allowance as a result of the termination of its war contracts in 1945. As pointed out above (note 2, p. 9), the taxpayer conceded below that it had a fixed right to a profit allowance when the contracts were terminated, and the issue litigated was whether the amount of income was reasonably ascertainable. The taxpayer cannot now be heard to argue that it had no such right in 1945.

The third reason for review urged by taxpayer (Pet. 18-21) is that the question of accrual of income resulting from termination of Government contracts involves substantial revenue and many taxpayers. However, the issue is of little, if any, importance for the future, since it relates to accruability of compensation for terminated Second World War contracts under the provisions of the Contract Settlement Act of 1944. Moreover, the decision turns on the application of settled accrual accounting principles to the facts of a particular case.

[illegible] The taxpayer asserts (Pet. 19) that the same question presented in this case continues to arise in the case of "[illegible] military contracts terminated for the convenience of the Government". However, it refers to no other pending case [illegible] of note.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

ARCHIBALD COX,
Solicitor General.

LOUIS F. OBERDORFER,
Assistant Attorney General.

HARRY BAUM,
HAROLD M. SEWELL,
Attorneys.

JUNE, 1961.

Table of Contents

	Page
Question Presented	1
Statutes and Regulations Involved	3
Statement	3
Argument	5
I. The Court of Claims erroneously held that a profit allowance from a negotiated settlement of a terminated Government contract was accruable as income in the year in which the negotiations reached a state of "sufficient agreement" for the amount of the profit allowance to be reasonably ascertained, instead of in the year when a binding settlement was reached	6
A. The Government's brief incorrectly analyzes the decision of the court below	6
B. The Court of Claims erroneously failed to apply the all-events rule and erroneously failed to hold that taxpayer's profit allowance did not accrue until the Settlement Review Board approved its settlement proposal in 1946	8
II. The decision of the Court of Claims is in conflict with the decisions of this Court on accrual tax accounting, decided in the October term, 1960	11
III. The conflict between the decision of the Court of Claims below and the decisions of this Court applying the all-events rule involves a principle of accrual of income from terminated Government contracts of importance to the revenue and of continuing application	16
Conclusion	18
Appendix	19

Table of Authorities Cited

Cases

Pages

American Automobile Association v. United States, 29 U.S. Law Week 4811 ..... 11, 15

Breeze Corporations v. United States, 114 F.Supp. 404 8

Commissioner v. Fifth Avenue Coach Lines, Inc., 281 F.2d 556, cert. den., 366 U.S. 964 ..... 12, 13

Com'r v. Milwaukee & Suburban Transport Corp., 29 U.S. Law Week 3378 ..... 11, 14, 15, 18

Consolidated Edison Co., U.S. v., 366 U.S. 380 ..... 11, 15

Continental Tie & L. Co. v. U.S., 286 U.S. 290 ..... 7, 8

Erie Basin M. Products, United States v., 244 F.2d 809 10

Fifth Avenue Coach Lines, Inc., Commissioner v., 281 F.2d 556, cert. den. 366 U.S. 964 ..... 12, 13

Globe Corporation, 20 T. C. 299, acq. 14

Liebes, H. & Co. v. Commissioner of Internal Revenue, 90 F. 2d 932 12

Masonite Corp. v. Fly, et al., 61-1 CCH USTC, par. 9355 .. 13

Milwaukee & Suburban Transport Corp., Comr. v., 29 U.S. Law Week 3378 ..... 11, 14, 15, 18

U.S. v. Consolidated Edison Co., 366 U.S. 380 ..... 11, 15

United States v. Erie Basin M. Products, 244 F.2d 809 10

Statutes and Regulations

Contract Settlement Act of 1944, c. 358, 58 Stat. 659 .....4, 6, 16

Treasury Regulations 111, sec. 29.42-1 ..... 8, 17

Joint Termination Regulation, 10 Fed. Register 10449, par. 583 ..... 10, 16

Income Tax Regulations, sec. 1.451-1, 26 C.F.R. 1.451-1 .... 3, 19

Miscellaneous

Mimeograph 5897, C.B. 1945, 131 8

Congressional Record (1944), Vol. 90, pp. 6061, 6130 10

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1961

No. 118

FOOD MACHINERY AND CHEMICAL CORPORATION, a corporation,
Petitioner,
vs.
THE UNITED STATES,
Respondent.

PETITIONER'S REPLY BRIEF

This is a suit to recover an overpayment of income and excess profits taxes and interest thereon for the taxable year ended September 30, 1945. Taxpayer's petition for a writ of certiorari to the United States Court of Claims was filed on May 26, 1961. The Government's brief in opposition was filed on June 23, 1961.

QUESTION PRESENTED

The Government's statement of the question presented in its brief in opposition is accurate as far as it goes,

but it does not disclose the real issue in this case. The real issue here is, as indicated in the Government's brief (n. 4, p. 12), the proper legal standard for determining the year of accrual of a profit allowance resulting from the negotiated settlement of Government contracts terminated for the convenience of the Government. The standard applied by the majority of the court below in holding that such income accrued in the fiscal year 1945 was a subjective standard, based on an appraisal of the state of settlement negotiations between taxpayer and the Government. The majority held that the negotiations between the parties had reached a stage of sufficient agreement by the end of the fiscal year 1945 for the amount of taxpayer's profit allowance to be considered reasonably ascertainable at that time (Pet., p. 40).

Taxpayer contends that the majority of the court below erred in failing to apply the proper objective standard based on the all-events principle of accrual of income. Taxpayer contends, as Judge Whitaker held in his dissenting opinion that such profit allowance was not accruable as income until the year 1946, when a binding settlement was reached (Pet., p. 44).

The issue in this case, therefore, is whether the court below correctly held that all the events had occurred which were necessary to fix the amount of and taxpayer's right to receive its profit allowance when the state of negotiations at the end of fiscal year 1945 provided a reasonable expectation as to the amount taxpayer might receive, but no binding settlement had then been reached and was not reached until 1946.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in taxpayer's petition for certiorari at page 3. Section 1.451-1 of the Income Tax Regulations on the taxable year of inclusion of items in income under the 1954 Revenue Code is set forth in the Appendix, infra, at pages 19-20.

STATEMENT

The facts will not be restated in detail, since they were set forth in taxpayer's petition for certiorari (pp. 3-9). However, certain inaccuracies and omissions appear in the Government's statement (Resp. Br., pp. 4-8). On page 5 of the Government's brief it is stated that taxpayer filed two joint inventory and settlement proposals, each covering four of the terminated contracts. While taxpayer received permission to do so, such settlement proposals were never filed. Difficulties which arose in the processing and apportioning of taxpayer's inventories on the basis of two joint claims prevented such filing (Finding 26, Pet., p. 57). Taxpayer, approximately two months after the close of the fiscal year 1945, filed one over-all claim embodied in its first settlement proposal, filed on November 27, 1945 (Finding 28, Pet., p. 57).

The statement in the Government's brief (p. 5) that the profit rate on which an understanding was reached on September 18, 1945, was subject to review by the Settlement Review Board in Washington, D.C., should be qualified to accord with finding 23 (Pet., p. 56) as follows:

"23. It was understood by and between the conferees for the parties at the pretermination conference, and by and between Mr. Davies and Captain Rosenstein at the meeting on September 18, 1945, that the 4.875 percent rate of profit would be subject to review by the defendant's Settlement Review Board in Washington. Negotiation was the only method of settlement used in settling plaintiff's termination claims, and all parties understood that written agreements would have to be reached."

The statement at the top of page 7 of the Government's brief that taxpayer made an explanation by letter in February, 1946, is incomplete. In addition to the explanation afforded by such letter of the variance between the estimated work in process and the amount reflected in taxpayer's claims, taxpayer agreed to waive certain substantial items of cost (Pet., p. 29; Findings 39 and 40, Pet., p. 62).

The Government is in error in stating in the first paragraph on page 8 of its brief that under the Contract Settlement Act of 1944 taxpayer had a right upon termination of its contracts to compensation for its material and labor expenditures and to a profit based on these costs. The Court held that under the Contract Settlement Act of 1944 the profit allowance for termination of taxpayer's contracts was left for negotiation by the parties and was to be a figure which would provide "fair compensation" to the contractor (Pet., p. 36). The Court held that the rate of profit was sufficiently established when the substance of the settlement proposal had been worked out between the contractor and the Government's contracting

officer, even though such agreement was tentative and not binding on either party, as was the case in the pretermination agreement negotiations (Pet., pp. 37-38; Finding 15, Pet., pp. 52-53; Finding 23, Pet., p. 56).

ARGUMENT

The Government opposes taxpayer's petition on the grounds that, in holding that taxpayer's profit allowance was properly accruable as income in the fiscal year 1945, the Court of Claims followed accepted rules of accrual basis tax accounting, and that there is no conflict and no occasion for further review. Taxpayer contends that the Court of Claims applied an improper rule for the accrual of taxpayer's profit allowance, and one which is in conflict with the accrual rules recently laid down by this Court during the October, 1950, term. Taxpayer further contends that this conflict should be resolved and the correct rule applied because of the important continuing question involved relating to the tax treatment of income from terminated Government contracts.

I

THE COURT OF CLAIMS ERRONEOUSLY HELD THAT A PROFIT ALLOWANCE FROM A NEGOTIATED SETTLEMENT OF A TERMINATED GOVERNMENT CONTRACT WAS ACCRUABLE AS INCOME IN THE YEAR IN WHICH THE NEGOTIATIONS REACHED A STATE OF "SUFFICIENT AGREEMENT" FOR THE AMOUNT OF THE PROFIT ALLOWANCE TO BE REASONABLY ASCERTAINED, INSTEAD OF IN THE YEAR WHEN A BINDING SETTLEMENT WAS REACHED

A. The Government's brief incorrectly analyzes the decision of the court below.

In discussing the decision of the court below the Government makes several erroneous statements. It is stated that taxpayer had a right to compensation for costs incurred under the terminated portions of the contracts for materials and labor, as well as an allowance for profit on these costs (Resp. Br., p. 9). As the court below correctly held, taxpayer's right to compensation under the Contract Settlement Act for termination of its contracts was a right to "fair compensation." The amount of fair compensation was left to negotiation between taxpayer and the Government, and the negotiations proceeded on the basis of according taxpayer various costs, including costs of raw materials and inventories, plus a negotiated rate of profit based on those costs.

The Government is grossly in error in its assertion that taxpayer conceded below that it had a "fixed right" to a profit allowance when the contracts were terminated, and that it is now seeking to raise a new issue in this Court by arguing that its right to receive its profit allowance did not become fixed until a binding settlement was reached in 1946 (Resp. Br., n. 2, p. 9, and p. 13). Taxpayer conceded only that on termination of its contracts

it had the right to receive "something" (Pet., p. 33). This was nothing more than a recognition that its unliquidated claim or cause of action against the Government for fair compensation arose at the time its contracts were terminated. It did not concede, as must be apparent from the opinion of the court below, that its right to a profit allowance was "fixed"[1] in a tax accrual sense at the time of termination of its contracts.[2]

The Government erroneously states that the court below applied the principles of *Continental Tie & L. Co. v. U.S.*, 286 U.S. 290, to the instant case, and that it made only a factual distinction between the instant case and the *Continental Tie* case (Resp. Br., pp. 9, 12). The court below clearly distinguished the *Continental Tie* case from this case on the basis of a legal, not a factual, difference between the cases. It held that the award in the *Continental Tie* case required only a *computation* which could be made from the books and accounts of the taxpayer, whereas the right to fair compensation in the instant case required *negotiation*, and could not be resolved solely by recourse to

[1]The Government's play on the term "fixed" is in keeping with its play on the term "objective" on page 13 of its brief, both of which references are calculated to cloud the issue presented.

[2]This is clearly apparent from the points stated in taxpayer's brief and reply brief filed in the Court of Claims. Heading II of taxpayer's brief reads as follows:

> "Plaintiff did not have a fixed, determined and enforceable right to receive a reasonably ascertainable amount of profit allowance on its terminated war contracts until 1946, the year of settlement of its termination claims."

Heading II of taxpayer's reply brief reads as follows:

> "Defendant's brief does not dispute plaintiff's contention that the Contract Settlement Act of 1944 by its terms did not prescribe a fixed, determined and enforceable right to a reasonably ascertainable amount of profit allowance."

the books and accounts of the taxpayer. The court below, therefore, as it had done previously in *Breeze Corporations v. United States*, 114 F. Supp. 464 rejected the position taken by the Government in Mimeograph 5897 (C.B. 1945, 131) and in its Regulations, in reliance on the *Continental Tie* case, that the profit allowance accrued at the time of termination.

While the Government cites Mimeograph 5897 and section 29.42-1 of Treasury Regulations 111 in its brief (Resp. Br., n. 3, p. 11), it does not now assert in its brief that taxpayer's profit allowance accrued at the time of termination of taxpayer's contracts, a position which it urged below and which was rejected by the court below. Instead it now seeks to uphold the decision of the court that the income was accruable when the rate of profit was reasonably ascertainable in the light of the negotiations between taxpayer and the Contracting Officer, even though by the close of the fiscal year 1945 the negotiations had not culminated in any binding settlement agreement. It is submitted that this decision is contrary to the tax accrual principles laid down by this Court and so recently affirmed during the October, 1960, term that income is not accruable until all of the events have occurred which fix the amount of the income and the fact of taxpayer's right to receive it.

B. The Court of Claims erroneously failed to apply the all-events rule and erroneously failed to hold that taxpayer's profit allowance did not accrue until the Settlement Review Board approved its settlement proposal in 1946.

The event relied upon by the court below as establishing the accrual of taxpayer's profit allowance was an

understanding reached between taxpayer and the Contracting Officer as to the rate of profit taxpayer would claim and which the Contracting Officer would recommend for allowance. This was reflected in a letter dated September 21, 1945. It is clear that the Contracting Officer had no authority to enter into a binding settlement of taxpayer's claim for a profit allowance on its terminated contracts. All he was authorized to do was to negotiate with the taxpayer and make recommendations on the taxpayer's proposed settlement. The law and the regulations expressly provide that no negotiated settlement in an amount in excess of $50,000 was binding on the Government until the proposed settlement had been reviewed and approved by the Settlement Review Board (Pet., pp. 74-75, 84-86; see also Findings 23, 42, Pet., pp. 56, 63). At the close of the fiscal year 1945 the taxpayer had not even filed its claim for compensation and did not file its first settlement proposal until November 27, 1945. It is thus clear that the Court of Claims based its accrual of the profit allowance on an appraisal of the state of negotiations between taxpayer and the Government on the settlement of its claim, for not only had the taxpayer's claim not been allowed prior to the end of fiscal year 1945, but it had not even been submitted.

The court below made no mention in its opinion of the all-events rule for accrual. Yet this Court has repeatedly held, and so recently affirmed in the cases decided at the October term, 1960,[3] that accrual of income must await all the events that fix the fact and amount of the right to

[3]These cases are discussed infra at pp. 11-15.

receive it. That all such events had not occurred prior to fiscal 1945 is clearly apparent. Not until the Settlement Review Board approved taxpayer's settlement proposal was there any binding liability on the part of the Government to pay a profit allowance (*United States v. Erie Basin M. Products*, 244 F.2d 809).

The court below was in error in stating that the agreement between the contractor and the Government Contracting Officer established the taxpayer's right to a reasonably ascertainable amount (Pet., pp. 37 and 38). There was no agreement in a contract sense between taxpayer and the Contracting Officer (Finding 23, Pet. p. 56). All that occurred prior to the close of fiscal year 1945 was an understanding that taxpayer would propose a settlement and the Contracting Officer would recommend its acceptance by the Settlement Review Board. The discretion as to whether the settlement proposed by taxpayer would be accepted and made binding on the Government rested with the Settlement Review Board.[4] In this case at the hearing on taxpayer's claim the Board considered the evidence, discussed the various items of the claim, and gave its approval on March 27, 1946 (Finding 42, Pet., p. 63).[5] As dissenting Judge Whitaker held, this was the event that

---

[4]In the House debate on the Contract Settlement Act of 1944, Mr. Vinson disclosed that the express purpose of providing for review by the Settlement Review Board was to vest the Board with the discretion of binding the Government on settlements involving large sums of money (90 Cong. Rec. 1944, 6061, 6130).

[5]Under the regulations describing the scope of review of the Settlement Review Board, it was authorized to inquire into specific selected items of the proposed settlement and could act upon records submitted by the Contracting Officer or require the submission of additional information (J.T.R. 583, Pet., pp. 85-86).

fixed the fact and the amount of taxpayer's right to receive its profit allowance (Pet., p. 44).

II

THE DECISION OF THE COURT OF CLAIMS IS IN CONFLICT WITH THE DECISIONS OF THIS COURT ON ACCRUAL TAX ACCOUNTING, DECIDED IN THE OCTOBER TERM, 1960

When the petition was filed in this case this Court had not yet decided the cases of *American Automobile Association v. United States*, 29 U.S. Law Week 4811, *U.S. v. Consolidated Edison Co.*, 366 U.S. 380, and *Comr. v. Milwaukee & Suburban Transport Corp.*, 29 U.S. Law Week 3378. They are therefore not discussed in taxpayer's petition. The Government's brief was filed on June 23, 1961, after these cases were decided, but made no mention of them. The position of the Government as to the application of the tax accrual principles laid down in those cases to the instant case is therefore not disclosed. However, it is manifest that the decision of the court below is in direct conflict with the accrual tax accounting principles set forth in those cases. The Court of Claims in the instant case accrued the profit allowance when it considered that the amount thereof was reasonably ascertainable. However, under the all-events rule as laid down by this Court in the above cases, an item of income or expense does not accrue when a reasonable estimate of the amount can be made; rather this court has held that an item of income or expense does not accrue until all of the events have occurred which fix the amount, as well as the fact of

liability to pay it in the case of an expense, or the right to receive it in the case of income.

The instant case parallels two cases considered by this Court in the October, 1960, term, one case in which certiorari was denied, the other case in which the Government's petition for certiorari was granted and the decision below vacated per curiam. In the first case, *Commissioner of Internal Revenue v. Fifth Avenue Coach Lines, Inc.*, 281 F.2d 556, certiorari denied 366 U.S. 964, the question involved was the year of accrual of a deduction for interest on a judgment against the taxpayer. The taxpayer claimed a deduction in the year in which a decision had been made on the part of its officers not to prosecute an appeal from the judgment rendered against it. The time for taking the appeal, however, did not expire until the next year. The Second Circuit Court of Appeals held that the all-events rule required that the deduction for interest await the expiration of the time for appeal, because not until then had all the events occurred to fix the liability. At page 559 it cited with approval the decision of the Ninth Circuit in *H. Liebes & Co. v. Commissioner of Internal Revenue*, 90 F.2d 932, where the court stated as follows:

> "If appeal is taken, the right is not fixed until determination of the appeal; and if no appeal is taken, * * * the right becomes fixed on termination of the appeal time."

In the *Fifth Avenue* case the Second Circuit Court pointed out that, while such a standard might be termed mechanical, it offered a clear guide to taxpayers, promoted ease of administration and contributed to certainty of revenue.

It found neither theoretical nor practical justification for introducing the complexities involved in determining reasonableness of expectation of appeal. The court also pointed out the opportunity for manipulation if a subjective standard based on intent was applied. The decision of the court below in this case is based on the subjective standard of intent rejected by the Second Circuit in the *Fifth Avenue* case, because it is based on an appraisal of the state of negotiations between the parties.[6] Awaiting the binding administrative action on its settlement proposal, as taxpayer contends, follows precisely the rule for accrual laid down by the Second Circuit in the *Fifth Avenue* case. Such a rule is objective, is not based on factors of intent, contributes to certainty, and promotes ease of administration. Having the accrual of the profit allowance await the binding action by the Settlement Review Board rests the accrual on the identifiable event which fixed the taxpayer's right to receive and the Government's liability to pay it.

The recent case of *Masonite Corp. v. Fly et al.*, 61-1 CCH USTC, par. 9355, illustrates this rule. There the question was the accrual as income of a refund of Mississippi income taxes. The taxpayer's right to a refund required the approval of the Attorney General of the state. The court held that the income did not accrue until the refund was approved.

---

[6]The Government's play on the word "objective" in its brief (p. 13) is no answer to taxpayer's contention that the Court of Claims rule for accrual is based on subjective factors, namely, the intent on the part of taxpayer to offer to settle its claims, and intent on the part of the Contracting Officer to recommend such settlement.

The decision of the court below is also contrary to the decision of the Tax Court in *Globe Corporation*, 20 T.C. 299, acq. While the court below distinguished the instant case from the *Globe* case on the ground that in the *Globe* case the negotiations had not reached any agreement, however tentative, on the amount or the method of computing fair compensation, it is clear that the Tax Court in the *Globe* case applied the all-events rule. It held that accrual was not required until all the events had occurred which fixed the amount and the right to receive the fair compensation, namely the entering into of a binding agreement as the result of the negotiations.

This case also resembles the *Milwaukee & Suburban Transport* case, supra. In that case the taxpayer, a common carrier filing its returns on the accrual basis, set up on its books a reserve account to reflect estimated amounts of contingent liabilities for contested and unsettled personal injury and property damage claims arising out of the operation of its transportation facilities, and deducted such amounts on its tax return. The Tax Court held that these estimated amounts were not accruable in the years in which they were claimed, since taxpayer's liability had not become definite but, on the contrary, was being contested. The Court of Appeals for the Seventh Circuit reversed, holding that, although taxpayer's liability for each individual claim was being contested and remained contingent, the aggregate amount of over-all liability could be accurately predicted. The Government petitioned for certiorari to this Court, stating:

> "In so holding the court below violated the settled annual accounting rule, and the equally settled corol-

lary principle that an item of deduction (expense, loss, etc.) is accruable as an offset against gross income only in the taxable year in which the liability to pay it becomes fixed, in *fact* as well as in *amount*" (No. 843, October Term, 1960, Pet., p. 7).

This Court, per curiam, supra, granted the Government's petition for certiorari and vacated the judgment below in the light of the *American Automobile Association* and *Consolidated Edison* cases. The same action is required here. The court below based its accrual, as did the Court of Appeals for the Seventh Circuit in the *Milwaukee & Suburban Transport* case, on a reasonably accurate prediction or estimate of the amount at the end of the taxable year. As the Government contended in the *Milwaukee & Suburban Transport* case, which contention was sustained by this Court in reversing the Seventh Circuit, the accrual of an item requires that it become fixed in fact as well as in amount. The amount of the profit allowance of taxpayer was not fixed when the Contracting Officer and taxpayer reached a tentative understanding as to the rate of profit that the taxpayer would claim in its settlement proposal and which the officer would recommend for allowance by the Settlement Review Board. It was not fixed until a binding settlement was reached by the action of the Settlement Review Board. Not until then had all of the events occurred necessary to fix the fact and the amount of taxpayer's right to receive its profit allowance, and not until then can the profit allowance be accrued as income. This Court should therefore take the same action that it took in the *Milwaukee & Suburban Transport* case, namely, grant certiorari in this case and vacate the judgment below.

III

THE CONFLICT BETWEEN THE DECISION OF THE COURT OF CLAIMS BELOW AND THE DECISIONS OF THIS COURT APPLYING THE ALL-EVENTS RULE INVOLVES A PRINCIPLE OF ACCRUAL OF INCOME FROM TERMINATED GOVERNMENT CONTRACTS OF IMPORTANCE TO THE REVENUE AND OF CONTINUING APPLICATION

One of the reasons urged by taxpayer for the review of this case was the substantial amount of revenue affected by the question of the accrual of income from terminated Government contracts involved in this case. The Government does not refute taxpayer's assertion that the rules governing the allowance of compensation for terminated Armed Services contracts today are precisely the same as those governing the allowance of compensation under the Contract Settlement Act of 1944. It does not refute taxpayer's statement as to the large number of terminated Armed Services' contracts and enormous amounts currently involved in the settlement of such claims. It contents itself with stating that the issue is of little, if any, importance for the future, since it relates to the accruability of compensation under terminated World War II contracts (Resp.Br., p. 13). However, the Joint Termination Regulation which governed the settlement of terminated war contracts under the Contract Settlement Act of 1944 is precisely the same as the Armed Services Procurement Regulations currently in force which govern the settlement of terminated Armed Services contracts. The question of the proper year for the accrual of profit allowances under contracts now being terminated under the Armed Services Procurement Regulations must therefore be precisely the same as the question

here presented of the proper year for accrual of profit allowances on war contracts terminated under the Contract Settlement Act. It is no answer to say that the Government now knows of no other pending cases. The issue is the same and cases will surely arise if this Court permits this erroneous decision of the Court of Claims to remain unreversed, and the Government seeks to apply it. If, instead, the Government will follow the correct rule as contended for by the taxpayer, then it will be manifestly unjust to leave standing the decision of the court below to the contrary.

The Government in this case, while seeking to uphold the decision of the court below, nowhere states in its brief what it contends is the correct rule for accrual of income from terminated Government contracts. It is significant that the regulation under the 1954 Code setting forth the general rule for the taxable year of inclusion of income omits the rules relating to income from terminated Government contracts which appeared in Treasury Regulations 111 under the 1939 Code applicable to this case. These omissions are shown in the appendix. The regulations presently in force do not contain any express statement that claims for compensation from cancelled or terminated Government contracts must be included as income in the year in which they are allowed. If this change in the regulations and the Government's position before the Court in this case that the decision below is correct means that the Government's position now is that claims for compensation under cancelled or terminated Government contracts are accruable as income, not in the year in which they are allowed, but rather in the year

in which the state of negotiations permit a reasonable ascertainment of the amount of compensation to be allowed, then indeed is this case of far reaching importance. This Court should clear up the confusion and uncertainty that would arise from an acceptance of the decision of the Court of Claims.

Even if this Court does not, as taxpayer respectfully submits should be done, grant certiorari and reverse the decision below on the authority of the *Milwaukee & Suburban Transport* case, supra, it should at least grant certiorari to resolve as a rule of law on the accrual of income from terminated Government contracts which is of continuing importance, not only to the revenues, but to a large number of taxpayers as well.

CONCLUSION

For the reasons stated above the petition for a writ of certiorari should be granted and the judgment of the court below vacated.

Dated: August 28, 1961.

Respectfully submitted,

HARRY R. HORROW,
Attorney for Petitioner.

ROBERT W. MORRISON,
PILLSBURY, MADISON & SUTRO,
Of Counsel.

(Appendix Follows)

Appendix

INCOME TAX REGULATIONS, promulgated under the 1954 Code

§ 1.451-1. General rule for taxable year of inclusion (a) *General rule.* Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. To the extent that income is attributable to the recovery of bad debts for accounts charged off in prior years, it is includible in the year of recovery in accordance with the taxpayer's method of accounting, regardless of the date when the amounts were charged off. [Except as otherwise stated in this sub-

section, such items as claims for compensation under canceled Government contracts constitute income for the year in which they are allowed or their value is otherwise definitely determined, if the return is rendered on the accrual basis; or for the year in which received, if the return is rendered on the basis of cash receipts and disbursements. In the case of a termination of a war contract as defined by section 3 of the Contract Settlement Act of 1944 (or the termination of any other Government contract as to which the right to compensation is definitely fixed and the measure thereof is determinable with reasonable accuracy), if the return is rendered on a basis other than cash receipts and disbursements, compensation for the termination shall, unless a different method of reporting is prescribed or approved by the Commissioner, constitute income for the taxable year in which falls the effective date of the termination, except that if any part of the compensation is attributable to cost, expenses, or losses incurred in a subsequent year such part of the compensation shall be returned as income for the subsequent year.] For treatment of bad debts and bad debt recoveries, see sections 166 and 111 and the regulations thereunder.

* * *

Bracketed material omitted.

26 Code of Federal Regulations (Revised as of January 1, 1961) § 1.451-1.

INDEX

CITATIONS

Cases:

	Page
American Automobile Assn. v. *United States*, 367 U.S. 687	1, 3, 5, 6, 7
Brown v. *Helvering*, 291 U.S. 193	2, 8
Commissioner v. *Fifth Avenue Coach Lines, Inc.*, 281 F. 2d 556, certiorari denied, 366 U.S. 964	4, 6
Commissioner v. *Hansen*, 360 U.S. 446	2
Commissioner v. *Milwaukee & Suburban Transport Corp.*, 367 U.S. 906, vacating and remanding 283 F. 2d 279	2, 3, 4, 6, 7, 8
Continental Tie & L. Co. v. *United States*, 286 U.S. 290	2, 4, 8
Dixie Pine Co. v. *Commissioner*, 320 U.S. 516	2
Lucas v. *American Code Co.*, 280 U.S. 445	2, 8, 9
Security Mills Co. v. *Commissioner*, 321 U.S. 281	2, 5
Spring City Co. v. *Commissioner*, 292 U.S. 182	2, 4–5
United States v. *Anderson*, 269 U.S. 422	2
United States v. *Consolidated Edison Co.*, 366 U.S. 380	1, 3, 6, 7, 8, 10

In the Supreme Court of the United States

OCTOBER TERM, 1961

No. 118

FOOD MACHINERY AND CHEMICAL CORPORATION, PETITIONER

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

SUPPLEMENTAL BRIEF FOR THE UNITED STATES IN OPPOSITION

This memorandum is filed pursuant to the Court's request of October 5, 1961, that the government respond to the taxpayer's reply brief submitted in support of its petition for a writ of certiorari.

1. The essence of taxpayer's reply brief is that (p. 5) the decision of the Court of Claims in this case "is in conflict with the accrual rules recently laid down by this Court during the October, 1960, term." Specifically, the reply brief refers (p. 11) to the following cases: *American Automobile Assn.* v. *United States,* 367 U.S. 687; *United States* v. *Consolidated Edison Co.,* 366 U.S. 380; and *Commissioner*

v. *Milwaukee & Suburban Transport Corp.*, 367 U.S. 906, vacating and remanding 283 F. 2d 279. None of those cases, we submit, in any way impairs the well-settled rule of annual tax accounting, as applied to taxpayers on the accrual basis, that an item of gross income is accruable in the year the taxpayer's right to the income becomes fixed, and the amount of the income becomes reasonably ascertainable. *Continental Tie & L. Co.* v. *United States,* 286 U.S. 290; *Spring City Co.* v. *Commissioner,* 292 U.S. 182, 184–185; *Commissioner* v. *Hansen,* 360 U.S. 446, 463–464. To the contrary, each of those cases represents an affirmative application of the basic annual accounting rule, or of its equally well-settled corollary, that an item must be deducted by an accrual basis taxpayer in the year his liability to pay becomes fixed, and the amount of the liability can be reasonably ascertained. *United States* v. *Anderson,* 269 U.S. 422, 437–438, 440–441; *Lucas* v. *American Code Co.,* 280 U.S. 445, 449–450; *Brown* v. *Helvering,* 291 U.S. 193, 200; *Dixie Pine Co.* v. *Commissioner,* 320 U.S. 516, 519; *Security Mills Co.* v. *Commissioner,* 321 U.S. 281, 286–287.

The court below correctly applied those established principles to the facts of this case. It held that since the taxpayer had acquired during the taxable year (fiscal 1945) a fixed right to receive compensation by reason of the termination of its war contracts, and since the amount receivable had also become reasonably ascertainable before the end of that year, it was required to accrue and report the income in that year, not in some later year. Contrary to taxpayer's

assumption, in so holding the court below did not depart from accrual principles recently reaffirmed by this Court in *American Automobile Assn.*, *Consolidated Edison*, and *Milwaukee & Suburban*.

Taxpayer's mistaken reliance upon *American Automobile Assn.* and related cases stems from its confusion of two distinct (albeit component) factors entering into a determination of the accruability in a given taxable year of an item of gross income or deduction: (1) whether the right to receive (an income item) or the liability to pay (a deduction item) became fixed during the taxable year; and (2) whether the amount receivable or payable was also reasonably ascertainable during the taxable year. The second inquiry is not reached, of course, unless the first is answered in the affirmative; for even though the amount of a contingent right or liability is known, the fact that the right or liability remains contingent during the taxable year in and of itself precludes accrual for tax accounting purposes.

American Automobile Assn., *Consolidated Edison*, and *Milwaukee & Suburban* each involved attempts to offset against or deduct from gross income contingent liabilities—*i.e.*, anticipated expenses, liability for which had not yet become fixed in fact during the taxable year—and in each case it was held that the liabilities had not yet ripened into deductible expenses of the taxable year.[1] Here, on the other hand, as the

[1] In *American Automobile Assn.*, the contingent liabilities consisted of estimated expenses for future services which the taxpayer might be called upon to perform for its members subsequent to the taxable year. In *Consolidated Edison*, they

court below found (Pet. 40) and the taxpayer concedes (Pet. 31, 33; Reply Br. 6–7), the taxpayer had a fixed right to receive some amount of compensation on account of the government's termination of the contracts; the only issue, to which the court below properly addressed itself, was whether the amount receivable could be determined with reasonable accuracy. On the basis of all the evidence it found that by the end of the taxable year settlement negotiations had proceeded to the point where the amount which the taxpayer had a fixed right to receive was reasonably ascertainable.[2] Applying accrual accounting principles enunciated by this Court in *Continental Tie & L. Co.* v. *United States, supra,* and repeatedly reaffirmed by this Court (*e.g., Spring City Co.* v. *Commissioner, supra; Security Mills Co.* v. *Commissioner,*

---

consisted of real estate tax claims paid by the taxpayer under protest but still being contested during the taxable year. In *Milwaukee & Suburban*, they consisted of an estimated amount payable in satisfaction of accident claims which were still being contested during the taxable year.

Commissioner v. *Fifth Avenue Coach Lines, Inc.*, 281 F. 2d 556 (C.A. 2d), certiorari denied, 366 U.S. 964, upon which taxpayer also relies (Reply Br. 12), likewise involved the deductibility of a contested liability—interest on a judgment which had not yet become final during the taxable year.

[2] The taxpayer conceded below (Pet. 33) and again concedes here (Reply Br. 6-7) that upon termination of the contracts it acquired a fixed right to receive "something," and the dispute accordingly centered on whether the amount receivable could be ascertained with reasonable accuracy. After carefully analyzing the evidence (Pet. 23–39), the court below concluded that (Pet. 40) "under the facts and circumstances of this case, negotiations between the parties had reached a stage of sufficient agreement by the end of fiscal 1945 for the amount of plaintiff's profit allowance to be considered reasonably ascertainable at that time."

supra; Commissioner v. *Hansen, supra*) it correctly held that the amount was accruable as income in the taxable year. There is nothing in this Court's opinions in the *American Automobile Assn.* and related cases, or, for that matter, in any of this Court's other opinions applying the annual accounting rule and corollary accrual principles, which in any way detracts from the correctness of the decision below.

In *American Automobile Assn.* v. *Commissioner, supra,* the gross income in question (annual membership dues) had in fact been received by the taxpayer during the taxable year. The only question was whether the taxpayer—despite its actual receipt and control of a known amount of income—could nevertheless "defer" accruing and reporting a portion of the income to a subsequent taxable year when it expected to incur certain allegedly related expenses. Applying the "annual accounting" rule, the Court held (pp. 690–692) that deferral of the income was improper because the taxpayer's liability to pay the claimed offsetting expenses had not become fixed during the taxable year but remained contingent. The Court pointed out (pp. 692–694) that a reasonable estimate of the future expenses "on a group or pool basis" did not suffice to transform what were otherwise individual contingent liabilities into fixed ones, and therefore concluded that admittedly contingent individual expenses could not be accrued. In this case, petitioner's right to the income was not contingent in the year in which the court below held that it accrued, and there is nothing in the *American Automobile Association* case which bears upon whether the amount was sufficiently ascertainable.

Taxpayer's reliance on *Consolidated Edison Co., supra*, is similarly misplaced. There, the taxpayer was contesting a local real estate tax which it had paid under protest as the only means of securing judicial review of the valuation on which the tax was based, and as the only means of avoiding interest, penalties, and the seizure and sale of its property. The government contended that inasmuch as the taxpayer had in fact paid the taxes assessed, and thus satisfied its liability therefor, it should be required to deduct (*i.e.*, accrue) that liability on its return for the year of payment even though the taxpayer's ultimate liability for the tax remained a matter of dispute. The Court rejected this contention, holding (pp. 391-392) that the taxpayer's "payment" amounted to "a mere deposit," and therefore that the disputed liability was properly accruable only in the later year when all the events had occurred finally to determine the dispute, *viz.*, in 1951 when the state court's order fixing taxpayer's liability became final. See also *Commissioner* v. *Fifth Avenue Coach Lines*, 281 F. 2d 556 (C.A. 2d), certiorari denied, 366 U.S. 964. Thus the only question affected by *Consolidated Edison* is the effect of a cash payment or cash receipt in advance of the normal time for accruing an income or liability item. The instant case does not involve such a question, and nothing in *Consolidated Edison* suggests any departure from the previous accounting standards for determining when a liability or income item should be accrued.

Finally, in *Commissioner* v. *Milwaukee & Suburban Transport Corp., supra*, vacating and remanding 283 F. 2d 279 (C.A. 7th), an accrual basis taxpayer de-

ducted the amount which it estimated to be its potential liability on unsettled accident claims. On none of the claims did the taxpayer admit liability. In fact, the taxpayer was vigorously contesting many of the claims in court. The Tax Court, in a memorandum decision dated November 18, 1959 (1959 P-H T.C. Memorandum Decisions, par. 59,216), sustained the Commissioner's disallowance of the deduction, finding (a) that "the existence of petitioner's liability respecting the unsettled claims of each year did not become definitely fixed during such year"; and (b) that "the amount of petitioner's liability in respect of unsettled claims of each year was not ascertainable within such year, with reasonable certainty." The Court of Appeals reversed, holding that because the accidents giving rise to the claims had occurred by the year's end, all the events had occurred which established liability; the fact that taxpayer was contesting each individual claim was not deemed controlling. Furthermore, on the issue of reasonable ascertainability of the amount of liability, the Court of Appeals disagreed with the Tax Court, holding that even though none of the claims could be individually evaluated, they could be estimated in the aggregate (or on a group or pool basis) with a fair degree of accuracy. However, this Court (367 U.S. 906) remanded the case to the Seventh Circuit in the light of *American Automobile Assn.* and *Consolidated Edison*, and upon the remand, the Seventh Circuit vacated its prior decision and affirmed that of the Tax Court. 61-2 U.S.T.C. par. 9653. In no sense can this disposition of the *Milwaukee & Suburban* case be regarded

as a rejection or modification of the established accrual rules.

As the foregoing analysis shows, none of the accrual accounting decisions rendered by this Court during the October Term, 1960, "conflicts" (Reply Br. 5) with the accrual rules established by the earlier decisions of this Court, particularly *Continental Tie & L. Co.* v. *United States*, 286 U.S. 290.

2. There is no merit in taxpayer's argument (Reply Br. 11–15) that the "all events" test followed by this Court in *Consolidated Edison Co.* contemplates something more than a fixed right to receive a reasonably ascertainable amount of income in order to require accrual.[3] The opinions of this Court in *Lucas* v. *American Code Co.*, 280 U.S. 445, and *Continental Tie & L. Co.* v. *United States*, 286 U.S. 290, establish that mathematical certitude is not essential to accrual. See, also, *Brown* v. *Helvering*, 291 U.S. 193.[4] Taxpayer's attempt (Reply Br. 7–8) to distinguish the *Continental Tie* case on the ground that the amount involved

---

[3] Taken to its logical extreme, taxpayer's interpretation of the all events test would effectively postpone accrual until the amount of a fixed liability (or right to income) is established down to the last penny.

[4] In the *Brown* case, this court stated (p. 200) that

> * * * where a liability has "accrued during the taxable year" it may be treated as an expense incurred; and hence as the basis for a deduction, although payment is not presently due. *United States* v. *Anderson*, 269 U.S. 422, 440, 441; *American National Co.* v. *United States*, 274 U.S. 99; *Aluminum Castings Co.* v. *Routzahn*, 282 U.S. 92; and although the amount of the liability has not been definitely ascertained. *United States* v. *Anderson*, *supra*. Compare *Continental Tie & Lumber Co.* v. *United States*, 286 U.S. 290, 296.

there required "only a computation", whereas the amount involved in the instant case required "negotiation", is unavailing. Thus, in *Lucas* v. *American Code Co., supra*, p. 450, this Court recognized that a loss from breach of contract would be deductible by an accrual basis taxpayer "where, within the tax year, there is a definite admission of liability, negotiations for settlement are begun, and a reasonable estimate of the amount of the loss is accrued on the books." Similarly, taxpayer here was required to accrue income for the taxable year in question because the right thereto became fixed upon termination of the contracts, negotiations for settlement had begun, and the amount of the income was ascertainable with reasonable accuracy. The fact that negotiations are required to fix the precise amount of a settlement may well be an important consideration in determining whether or not an amount is reasonably ascertainable, but it certainly does not preclude an affirmative finding in that regard. In the instant case, the Court of Claims took all the facts into account, including the negotiations, and found on the evidence as a whole that taxpayer's right to income was reasonably ascertainable in amount. This finding is fully supported by the record and should not be disturbed.

3. Taxpayer's unsupported and belated assertion (Reply Br. 6) that its right to fair compensation did not become fixed during the taxable year in question is completely inconsistent with its admission (Reply Br. 6–7) that it had the right to receive "something" on termination of its contracts, *i.e.*, that it had an "unliquidated claim * * * against the

Government for fair compensation." At no time did the government contest or in any way deny taxpayer's right to fair compensation under the Contract Settlement Act. To the contrary, both contracting parties recognized, assumed, and admitted that taxpayer had such right when the contracts were terminated, the only unresolved question being the precise amount of the compensation to be paid. Cf. *Consolidated Edison Co., supra,* where taxpayer contested its liability to pay any additional taxes. As demonstrated in our Brief in Opposition (pp. 10–12), as held by the Court of Claims, and as clearly indicated by the evidence, the amount of compensation, while not determined with precision as of the close of the taxable year, was nevertheless ascertainable with reasonable accuracy. Hence, under established accrual rules, it was properly includible in gross income for that year.

For the reasons stated above, and the additional reasons set forth in the Government's Brief in Opposition, the petition for a writ of certiorari should be denied.

Respectfully submitted.

ARCHIBALD COX,
Solicitor General.
LOUIS F. OBERDORFER,
Assistant Attorney General.
HARRY BAUM,
HAROLD M. SEIDEL,
BURT J. ABRAMS,
Attorneys.

NOVEMBER 1961.

U. S. GOVERNMENT PRINTING OFFICE 1961